LAW AND CONTEMPORARY PROBLEMS

SMALL BUSINESS

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LAW AND CONTEMPORARY PROBLEMS

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THE SPRING, 1959 ISSUE OF

LAW AND CONTEMPORARY PROBLEMS

will be devoted to

a symposium on

STATE TRADING

LAW AND CONTEMPORARY PROBLEMS

VOLUME 24 WINTER, 1959 NUMBER 1

FOREWORD

Americans have been troubled for several decades about—to use Justice Brandeis' phrase—the "curse of bigness." Even though the onrush of technology has made it necessary to rely on the very biggest concerns for achievement of certain objectives, such as the production of steel or of intercontinental ballistic missiles, the United States remains committed to the premise that small business has a unique and indispensable role in our society. Reaffirmation of this commitment is evidenced by the permanency recently granted to the Small Business Administration, by establishment of Small Business Committees in both houses of Congress, and by enactment last summer of several laws intended to provide tax relief and new sources of credit for small business.

No extensive justification need be attempted here for a policy that seeks to preserve small business. Often, the existence of small business fosters vigorous economic and intellectual competition,which has, in the past, often engendered significant progress. Many instances could be recited of small firms that became the vehicles for new and successful ideas. Moreover, the ownership of one's own business—like the extensive home ownership that has been encouraged in this country—may yield benefits in terms of an enhanced initiative and responsibility, sometimes less attainable by mere employees, however well-paid. The increased responsibility may, in turn, result in a net gain in economic efficiency. In the political realm, the danger to democracy that ensues when economic power is concentrated in the hands of a few persons, be they a few big businessmen or a few labor leaders, is well understood.

The significance of small business induced *Law and Contemporary Problems* to publish a symposium in this field in 1945. Financing the small entrepreneur, which was the focal problem of that symposium, is, of course, re-examined in the following pages. To what extent, it is inquired, is smallness a disadvantage when either long-term financing or working capital is being sought? When is aid from the federal government or from state or local agencies available to rectify any such disadvantage?

Tax considerations must also loom large in the small businessman's calculations. For instance, in determining what equipment to purchase, he must consider what depreciation he can write off for tax purposes. Sometimes the very complexity of

the Internal Revenue Code and of state tax legislation may leave him frustrated and envious of the large concern that can afford the services of expensive tax consultants. Sometimes, on the other hand, the complexity of the tax structure may aid him by providing a lure with which to attract investors who either may be seeking a long-term capital gain in a small "growth corporation" or, by virtue of the latest tax revisions, may consider that an unsuccessful investment in a small corporation is hedged in advance by the privilege of taking an ordinary, rather than a capital, loss.

Perhaps it is merely another aspect of what one prominent personage has denominated "creeping socialism," but the small entrepreneur must cope with government on several fronts besides taxation. With defense expenditures so prominent in the national budget, he must determine how to get a share in military production or research and development contracts—a task made all the more difficult by the increasing use of the weapon-system concept in procurement. Regulatory commissions and agencies, too, must frequently be confronted—either to obtain franchises and licenses or to seek governmental aid in resisting questionable practices employed by large competitors.

The small business may lack the resources to survive lengthy and expensive proceedings before a regulatory commission or a protracted strike by its employees. Often, it will not have the wherewithal for obtaining expensive machinery or personnel requisite for effective competition in some industries. Whether these and other factors have actually resulted in a trend towards greater economic concentration in the United States and other countries is a question that economists have hotly debated. Controversy also rages as to whether small business can improve its position substantially either through self-help, in the form especially of co-operatives, or through further governmental assistance, which inevitably raises the specter of possible governmental control.

The present symposium is projected against a backdrop of timeliness—indeed, of urgency. Accordingly, it is hoped that the ideas here ventilated will provoke discussion and thereby, perhaps, prove helpful in clarifying, and even facilitating the solution of, some of the problems presently confronting small business.

ROBINSON O. EVERETT

WHAT GOVERNMENT EFFORTS ARE BEING MADE TO ASSIST SMALL BUSINESS

WENDELL BARNES*

The President's Council of Economic Advisers has stated,[1]

The Federal Government makes its greatest contribution to the welfare of small business by following policies that help maintain stable prosperity. A vigorous growing economy offers ample opportunities not only for established firms to grow in size and strength, but also for new businesses to be started. Small businesses are aided in this respect by Federal policies that maintain confidence on the part of investors, businessmen and consumers, that eoncourage risk taking and that preserve and strengthen competition.

The best testimonial to the vitality of small business is the number of small businesses in our economy. It is inaccurate to say that small business is in a situation of distress today. The number of small businesses is at the highest level in all history. There were 4,323,000 businesses as of January 1, 1958, an increase of 33,700 over the preceding year. Of this number, nearly 4,200,000 may be considered as small. In the preceding year, there was an increase of 43,800, and in the year ending January 1, 1956, there was an increase of 56,200.

After World War II a large number of persons, prompted in part by the opportunities offered in the so-called "G. I. Bill," launched small business ventures. Since many of these people lacked experience, their prospects for survival were doubtful. As was to be expected, there have been casualties in sizable quantity. Despite this, the total number of small businesses has continued to increase. In fact, the number of such businesses in existence today is one-third greater than it was before the war.

It should be noted that bankruptcy figures may be misleading, and have, in fact, been subject to wide misinterpretation. Of the total number of bankruptcies in fiscal 1957—73,761—only 9,535 were business bankruptcies; all the rest were personal bankruptcies. The total bankruptcy figures, including preponderantly personal bankruptcies, therefore, should not be used as a small business indicator.

Small businesses benefit from a large number of federal policies and programs adopted to assist business concerns generally, both large and small, and from a growing number of programs designed specifically to help small concerns. I shall describe the most important of these policies and programs.

I

DEVELOPMENT OF SMALL BUSINESS PROGRAMS

Federal government assistance with the special problems of small business began in 1941. In that year, a Small Business Unit was established in the Bureau of Foreign

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[1] FEDERAL POLICIES AND PROGRAMS THAT BENEFIT SMALL BUSINESS 1 (1957).

and Domestic Commerce of the United States Department of Commerce, and it was directed to: (1) study the small business segment of the nation's industries; (2) determine the problems encountered by smaller firms because of their size; and (3) plan a program to assist the firms with their problems.

This small business program of the Commerce Department had been under way only a short time when World War II began. During the ensuing years, several of the projects initiated by the Commerce Department unit were adopted by the War Production Board and the Smaller War Plants Corporation. These projects related primarily to smaller manufacturers. The wholesale, retail, and service trades continued to be served by the Commerce Department. Throughout the war years, the Commerce Department carried on a limited small business program devoted chiefly to advice on management problems and the distribution of marketing and economic information.

The major effort to bring small manufacturers into war-supporting industries during World War II began with the establishment of the Smaller War Plants Corporation (SWPC) as a part of the War Production Board on June 11, 1942. Earlier attempts to increase small business participation in the war effort, first through the work of the Division of Contract Distribution of the Office of Production Management, and later through the work of two units of the War Production Board—the Contract Distribution Branch, Production Division, and the Bureau of Finance, Division of Industry Operations—had met with little success. By April 1943, the SWPC had been separated administratively from the War Production Board, although the Chairman of the Board of the SWPC continued to serve the War Production Board in an advisory capacity as its Vice-Chairman for Smaller War Plants.

The SWPC was authorized by Congress to carry on two broad types of activities: to help small manufacturers obtain prime and subcontracts for war production, and to make loans to small firms. Specifically, the SWPC was authorized to: (1) direct the attention of government procurement officers to the potential productive capacity of small plants, and to certify the competency, as to capacity and credit, of small businesses to perform procurement contracts; (2) assume government procurement contracts, which it could then subcontract to small firms; (3) encourage subcontracting by large prime contractors; (4) make loans to small plants for defense and essential civilian purposes; (5) make a complete inventory of productive facilities which could be used in the war effort; (6) approve war production pools; (7) lease or sell equipment and land to small business; (8) assist small firms in obtaining essential materials; and (9) assist manufacturers in solving their production problems.

Additional duties subsequently were given to the SWPC under the Contract Settlement Act, the Surplus Property Act, the Servicemen's Readjustment Act, and the War Mobilization and Reconversion Act.[2] The most important of these were to:

[2] 58 STAT. 649 (1944), 41 U.S.C. § 101 (1952); 58 STAT. 765; 58 STAT. 284 (1944), 38 U.S.C. §§ 693 *et seq.* (1952); 58 STAT. 785 (1944).

(1) make loans to small plants pending settlement of their government contracts, and to give other contract settlement assistance; (2) assist small businesses and veterans in obtaining surplus property, and to make loans to small businesses for this purpose; and (3) see that small businesses obtained a fair share of scarce materials as they were released to civilian production.

As of January 1946, the SWPC was abolished by Executive Order.[3] Its loan functions were transferred to the Reconstruction Finance Corporation, and its other functions to the Department of Commerce (except veterans' functions, which went to the War Assets Corporation). However, during the approximately three and one-half years of its existence, the SWPC had helped small plants to obtain about 54,000 prime contracts valued at over $6,000,000,000 and had made loans and leases to small plants amounting to approximately a half billion dollars.

The SWPC functions that were transferred to the Commerce Department were combined with the small business functions that the Department had continued during the war and were placed in a new unit, the Office of Small Business. The programs were modified, of course, to meet changed conditions. The main functions of the Office of Small Business were to: (1) assist small businesses with their management problems, such as record-keeping and advertising; (2) provide prospective small businessmen with basic information on the types of businesses they planned to enter; (3) assist state planning commissions and other groups in surveying the industrial and other resources of specific areas to determine what types of new small businesses could make use of the resources; (4) seek the elimination of monopolistic and unfair trade practices that were harmful to small business; (5) provide small manufacturers with information on government procurement and encourage the awarding of an increased proportion of contracts to small business; (6) study the tax problems of small business and the probable effect upon small business of proposed tax legislation, and make recommendations as to both; (7) study the over-all financial problems of small business and assist individual small businesses with their financial problems; and (8) help small manufacturers solve their production problems.

Following the passage of the Defense Production Act of 1950,[4] and the establishment of the National Production Authority, the Office of Small Business became a primary unit of the NPA. The office then began to devote most of its efforts to its government procurement program, research on production and economic problems of small business resulting from the defense program, and assistance to small business in obtaining scarce materials.

On July 31, 1951, by unanimous action, Congress created the Small Defense Plants Administration (SDPA) by adding section 714 to the Defense Production Act.[5] After establishment of the Small Defense Plants Administration, and assignment to it of

[3] Exec. Order No. 9665, Dec. 27, 1945; 10 FED. REG. 15365 (1945).
[4] 64 STAT. 798, 50 U.S.C. App. §§ 2061-66 (1952).
[5] 65 STAT. 131 (1951), 50 U.S.C. App. § 2163a (1952).

the major responsibility for increasing small business participation in the defense effort, many of the functions of the Office of Small Business were transferred thereto by the President. The principal functions of the Small Defense Plants Administration, as prescribed by Congress, were to see to it that small business: (1) obtained a fair share of defense contracts; (2) received a fair share of critical materials; and (3) obtained the financial and technical assistance needed to participate effectively in defense and essential civilian activities.

The SDPA provided a minimum of $723,744,379 worth of assistance to small business concerns, chiefly manufacturers, in its twenty-one months of operation. This is the total dollar value of government procurement (prime contracts and subcontracts) and loans obtained for small plants through the agency's efforts, and does not reflect the value of additional assistance for which methods of reporting and computing were not available.

In 1953, the Small Business Administration (SBA) was established as the first independent agency of the Government charged with the duty of fostering the interests of small business.[6] For the first five years of its existence, the SBA resembled the SWPC in the sense that it was only a temporary agency designed primarily to assist small business in meeting problems created by the defense effort. The most important difference between the two agencies was that the lending powers of the SBA were not, like those of the predecessor agency, confined to defense or essential civilian purposes. Even at this stage of its development, the SBA could and did make loans to small businesses for peacetime purposes. Indeed, most of its loans have been of that nature.

In 1958, the Small Business Act[7] was enacted to convert the SBA into a permanent establishment expressly authorized to assist small businesses in meeting *all* problems, including those which have no relation to national defense. This change in the character of the Administration resulted from the recognition, by the President and the Congress, that it was advisable to stabilize and strengthen the small business program and to extend its operations into the peacetime economy.

The authority of the SBA was broadened correspondingly. For example, the Act calls upon the SBA to explore all matters materially affecting the competitive strength of small business and to study the effect on small business of all federal laws, programs, and regulations. Similarly, programs to assist small business in obtaining government contracts are placed on a peacetime basis. The SBA is authorized to furnish such assistance for all types of federal procurement without the former requirement that the assistance be related to war or defense programs.

Even before the authority of the SBA was thus formally expanded to cover the peace-time needs of small business, the President had established a program integrating the resources of the federal government for the purpose of studying and

[6] 67 STAT. 232 (1953), 15 U.S.C.A. § 631 (Supp. 1959).
[7] 72 STAT. 384 (1958), 15 U.S.C.A. §§ 631-47 (Supp. 1959).

resolving all problems affecting this vital segment of the economy. On May 31, 1956, he established the Cabinet Committee on Small Business, composed of the Secretary of Defense, the Secretary of Commerce, the Secretary of Labor, the Director of the Office of Defense Mobilization, the Administrator of the Housing and Home Finance Agency, the Administrator of the Small Business Administration, and the Chairman of the Council of Economic Advisers. The latter is Chairman of the Committee. In his explanation of this action, the President declared:[8]

> The important contributions made by small business concerns to the progressive spirit and vitality of the American economy have repeatedly been stressed in my economic reports. . . . The Federal Government has a number of programs now in operation that are significantly helpful to small business. . . .
>
> These and other programs and policies of the Federal Government facilitate the establishment of new concerns and foster the growth of small businesses. Yet the conditions of our modern economy are such that many small concerns confront substantial hindrances to their growth. It is my wish that the Federal Government keep fully abreast of developments that affect small businesses. . . .
>
> To this end I am establishing a Cabinet Committee on Small Business. . . . The Committee is to have the continuing assignment of making specific recommendations to me for administrative actions and, where necessary for additional legislation, to strengthen the economic position of small businesses and to foster their sound development.

In its first *Progress Report,* dated August 7, 1956, the Committee made fourteen recommendations for the betterment of the interests of small business, nine of which have since been carried out. The first four recommendations, calling for changes in the tax laws, are reserved for separate discussion below. The remainder are considered here.

Number five, recommending a comprehensive review of procurement policies, including the legislation pertaining thereto, has been implemented by the Omnibus Procurement Act,[9] which makes it easier for small business concerns to do business with the Government by permitting extension to most civilian agencies of a modernized procurement code. In addition, it makes important improvements in connection with the authority to make advance and progress payments and simplifies payroll information required by the Anti-Kickback Act[10] relating to government construction and building repair contracts. This Act also facilitates further implementation of a related recommendation—number six—that administrative action be taken to remove certain obstacles which hinder or delay advance and progress payments to small contractors.

Number seven recommending that the Renegotiation Board encourage government contractors to subcontract their work by making it clear that such subcontracting is given favorable consideration in determining allowable profits, has been implemented by an appropriate amendment to the regulations of the Board.[11] Number

[8] CABINET COMMITTEE ON SMALL BUSINESS, PROGRESS REPORT app. 13-14 (1956).
[9] 72 STAT. 966 (1958), 41 U.S.C.A. § 252 and 40 U.S.C.A. § 276c (Supp. 1959).
[10] 48 STAT. 948 (1934), 18 U.S.C. § 874 and 40 U.S.C. § 276c (1952).
[11] Renegotiation Board Regs. § 1460.14, 2 CCH GOV'T CONT. REP. ¶ 26144 (1958).

eight, calling for an extension of the life of the Small Business Administration has been carried out by legislation[12] establishing the SBA as a permanent agency of the Government.

Number nine, recommending that the maximum amount of an issue of corporate securities which the Securities and Exchange Commission may exempt from registration be increased from $300,000 to $500,000, was embodied in a proposal[13] which passed the Senate on June 26, 1957. However, the House Committee on Interstate and Foreign Commerce, to which it was referred, took no action thereon. Number ten, calling for a conference on technical research, development and distribution, for the benefit of small business, was carried out by a conference held in Washington on September 24-26, 1958.

Number eleven recommends closer federal scrutiny of mergers. A bill implementing this proposal was reported from the House Committee on the Judiciary on May 28, 1957.[14] However, it made no further progress.

Number twelve, recommending procedural changes in the antitrust laws to facilitate their enforcement, was partially implemented by bills[15] which make cease and desist orders of the Federal Trade Commission final when issued, unless appealed to the courts. The Senate bill passed the Senate on July 15, 1958, but the House took no action on either. Number twelve was further implemented by a bill[16] providing that, when civil rather than criminal proceedings are being considered, the Attorney General be empowered to issue a civil investigative complaint compelling the production of relevant documents before the filing of a complaint, without having to invoke grand jury proceedings. No action had been taken on this bill when the Congress adjourned in 1958.

Number thirteen, recommending that wage reporting by employers for purposes of social security records and income tax withholding be simplified, was embodied in a bill which was still pending in the Ways and Means Committee when the Congress adjourned.[17]

Number fourteen recommends that the Office of Statistical Standards of the Bureau of the Budget undertake a comprehensive review of the reports and statistics required of small businesses. The Federal Reports Act of 1942[18] requires that any government agency which desires to collect information from private persons or businesses shall submit the plan or form to the Director of the Bureau of the Budget for approval. As part of its normal review, the Office of Statistical Standards now examines such plans from the standpoint of their effect as burdens on small business.

[12] 72 STAT. 384 (1958), 15 U.S.C.A. §§ 631-47 (Supp. 1959).
[13] S. 2299, 85th Cong., 1st Sess. (1957).
[14] H.R. 7698, 85th Cong., 1st Sess. (1957).
[15] S. 721 and H.R. 8682, 85th Cong., 1st Sess. (1957).
[16] S. 1023, 85th Cong., 1st Sess. (1957).
[17] H.R. 8309, 85th Cong., 1st Sess. (1957).
[18] 56 STAT. 1078, 5 U.S.C. §§ 139-39f (1952).

II

SMALL BUSINESS TAX BENEFITS

Until recently, the Department of the Treasury and Congress have been reluctant to give special consideration to small business tax problems. The Technical Amendments Act of 1958[19] represents a change in this attitude. It contains six changes in the tax laws which are of direct benefit to small business concerns. Three of these stem from recommendations made by the Cabinet Committee on Small Business in its first report of August 7, 1956, and another carries out a recommendation made by the President in a letter addressed, on July 15, 1957, to the Chairman of the House Committee on Ways and Means.[20]

Section sixty-four of the Act permits small corporations to be treated as partnerships for income tax purposes. Where all of the shareholders of such a corporation elect to take advantage of this provision, each shareholder will include in his own income, for tax purposes, his proportionate share of the current taxable income of the corporation, both the portion which is distributed and that which is not. The right to this election is limited to domestic corporations which have no more than ten shareholders and no more than one class of stock. This section applies to taxable years beginning after December 31, 1957.

In the case of undistributed corporate earnings, this election will be of value to shareholders who have marginal tax rates below the rate payable by the corporation. Where the earnings are distributed (and are in excess of what may properly be classified as salary payments), the benefit will extend to shareholders with somewhat higher rates, since, in this case, a "double" tax is removed. The section will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting such losses against taxable income at the corporate level and where the shareholders involved have other income which can be used as an offset.

In 1954, legislation was enacted permitting proprietorships and partnerships to elect to be taxed like corporations.[21] The combined effect of that elective right and the elective right granted by section sixty-four is to reduce the importance of tax consequences as a consideration in determining which of the three forms a business enterprise should assume.

Section 202 of the Act provides ordinary loss, rather than capital loss, treatment on stock of small business corporations which is sold or exchanged at a loss or which becomes worthless. This right is available only in the case of an individual and only if he is the original holder of the stock. To limit the benefits of this provision to small business, the aggregate of the stock offerings of any corporation which are eligible for the ordinary loss treatment is limited to $500,000. The total stock offering per corporation plus the equity capital of the corporation may not exceed

[19] 72 STAT. 1606 (codified in scattered sections of 26 U.S.C.).
[20] *Id.* §§ 64, 204, 206, and 202.
[21] INT. REV. CODE of 1954, § 1361.

$1,000,000. In addition, the maximum loss that can be taken by a taxpayer is $25,000 a year (or $50,000 in the case of a husband and wife filing a joint return).

The effect of section 202 is to bring shareholders in a small corporation closer, from the standpoint of risk, to the status of proprietors or partners. The result should be to make equity capital more readily available to small corporations.

Section 203 of the Act extends the former two-year net operating loss carry-back to a three-year carry-back with respect to losses carried back from the calendar year 1958 (or from the portion of a fiscal year falling in 1958) and the following years. Thus, a loss is first carried back to the third year before the year of the loss. If any loss then remains, it is carried to the second year before the loss, and any loss then remaining is carried to the first year prior to the loss. At that point, the carry-forward provisions of the law, which remain unchanged, come into play. Any loss still remaining is carried successively to the five years after the year of the loss.

The addition of one year to the net operating loss carry-back will not increase the loss offsets that have been available to small businesses, incorporated and unincorporated, since those which could not entirely offset a loss in the two prior years could usually do so against income in the five succeeding years. The primary intent of section 203 is to benefit small firms whose losses during calendar year 1958 exceed their 1957 and 1956 income. By taking their losses back to 1955, which was a good year for many, they may obtain badly needed money by way of tax refunds from the Government.

Section 204 of the Act permits a taxpayer to write off twenty per cent of the cost of depreciable, tangible personal property, having a useful life of six years or more, in the year of acquisition. This treatment, which is applicable to newly acquired used property as well as new assets, is available for taxable years ending after June 30, 1958, on property acquired after December 31, 1957. The benefits of section 204 are concentrated largely in the small business area by limiting that part of the cost of property, with respect to which the write-off can be taken, to a value not in excess of $10,000 ($20,000 in the case of a husband and wife filing a joint return).

A write-off of one-fifth of the total cost of an asset in the year of its acquisition, in addition to regular depreciation on the balance, will make it possible for small business to use depreciation reserves not only for replacement, but also, to a significant degree, for expansion. In addition, it should encourage additional investment in small business, since it provides for a faster recovery of capital before the taxing of earnings.

Section 205 of the Act relates to the accumulated earnings credit. In addition to the regular corporate income tax, the Internal Revenue Code of 1954 imposes an accumulated earnings tax (formerly called the section 102 tax) of 27-½ to 38-½ per cent on improperly accumulated corporate earnings.[22] In computing the income base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which are retained for the reasonable needs of the

[22] INT. REV. CODE of 1954, § 531.

business. Prior to the enactment of section 205, there was a minimum credit of $60,000 of earnings which could be accumulated before any income was subject to the accumulated earnings tax. This section raises that minimum to $100,000. It is effective with respect to taxable years beginning after December 31, 1957.

The accumulated earnings tax has presented an especially serious problem for small business, because the absence of specific plans for the future frequently makes it difficult for a small concern to establish the fact that the earnings are accumulated for reasonable needs of the business. In fact, it was this difficulty which initially led to the establishment of the $60,000 minimum. By raising this amount to $100,000, allowance is made for cost increases which have occurred since the original figure was established. It should be emphasized that the increase in the minimum credit is in no way intended an an indication that accumulated earnings in excess of $100,000 are necessarily subject to the earnings tax.

Section 206 provides that, where the value of an interest in a "closely held business" represents a significant portion of the base on which the federal estate tax is computed, the federal death tax can then be paid in ten annual installments rather than in one lump-sum payment fifteen months after the death of the decedent. To be eligible for this treatment, the interest in a closely held business (or the aggregate interests in several businesses, if the interest in each is more than half) must represent thirty-five per cent of the gross estate or fifty per cent of the taxable estate of the decedent. A "closely held business" is defined in the section as including a proprietorship, a twenty per cent capital interest in a partnership, a twenty per cent stock interest in a corporation, and an interest in a partnership or corporation in which there are ten or fewer partners or shareholders.

This tax deferral is, of course, available only with respect to the portion of the estate tax attributable to the value represented by the interest in the closely-held business. Installment payments made under a deferral arrangement are subject to interest at the rate of four per cent. Section 206 applies to estates of decedents where the date of filing the federal estate tax return falls later than September 2, 1958, the date on which the Technical Amendments Act of 1958 was enacted.

Section 206 is designed primarily to keep a business enterprise intact where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax. The hope is that, by spreading the period over which the estate tax may be paid, it will be possible to pay the estate tax out of the earnings of the business. This provision should play an important part in current efforts to prevent the absorption of small businesses by their larger competitors.

III

FINANCIAL ASSISTANCE PROGRAMS

The federal government has a number of programs for helping small business meet their credit and capital needs. Chief among these are the programs administered by the Small Business Administration, the first federal agency to be organized

with exclusive responsibility for helping small businesses solve their financing problems. The SBA places special emphasis on facilitating the access of small concerns to private sources of funds; however, where necessary, it extends credit directly to businesses that are unable to obtain adequate financing on reasonable terms.

In line with its policy of facilitating the access of small concerns to private sources of credit, the SBA participates with banks and other private lending institutions in the extension of credit to such businesses. Its participation loan programs are designed to help maintain the borrowing firm's relationship with its local bank and to encourage private lenders to make loans to firms applying for SBA assistance. Participation arrangements are of two types: (1) The SBA and the co-operating bank each advances part of the funds when the loan is first made; these are known as immediate participation loans. (2) The SBA does not advance any funds at the outset, but agrees at the option of the co-operating bank, to purchase up to a specified part of the loan at a later date; these are known as deferred participation loans. Where participation with a private lender cannot be arranged, the SBA may extend the full amount of the loan under its direct loan program.

Through December 31, 1958, the SBA had approved 8,977 participation loans, totaling approximately $443,000,000. Of this amount, the SBA share was $342,000,000; private lending institutions committed themselves to extend the remainder. About $317,000,000 has been disbursed by the SBA and co-operating banks under these participation loans as of December 31, 1958. The SBA has also approved 4,761 loans in which no participation with a private lending institution was involved. Under this direct loan program, $196,000,000 of credit was approved through December 31, 1958, and approximately $135,000,000 had been disbursed.

Participation loans and direct loans are made with maturities up to ten years, except that a loan made for the purpose of constructing facilities may have a maturity of ten years plus such additional period as it is estimated may be required to complete such construction. Prior to August 1958, the maximum interest rate was six per cent per annum; since that date the maximum rate on the SBA share has been reduced to 5-½ per cent per annum.

The SBA also has a special loan program called the Limited Loan Participation Program, particularly designed to meet the credit needs of small retail, wholesale, and service firms. Under this program, approval of a loan can be authorized by the Regional Director of any one of the SBA's fifteen regional offices if (1) at least twenty-five per cent of the loan is extended by a private financing institution, (2) participation by the SBA is not over $15,000, and (3) the loan terms call for full repayment in monthly installments over a period not exceeding five years. The maximum interest rate on the SBA share of these loans was also reduced from six per cent to 5-½ per cent in August 1958. Through December 31, 1958, 3,662 loans totaling $53,600,000 had been approved under this program. These figures are included in the data shown above for participation loans.

Under the so-called "pool loan" program, the SBA makes loans to corporations formed and capitalized by a group of small business concerns for the purpose of obtaining for the use of such concerns raw materials, equipment, inventories, supplies, or the benefits of research and development, or for establishing facilities for such purpose. These loans are limited by the Small Business Act of 1958 to a maximum of $250,000 multiplied by the number of small businesses that have established the pool corporation. To date, only three business loan applications have been received under this program, all of which were approved.

The volume of SBA business lending activities is summarized in table one:

TABLE I
BUSINESS LENDING ACTIVITY OF THE SMALL BUSINESS ADMINISTRATION, OCTOBER 1953 THROUGH DECEMBER 1958

Item	Total Loan Program	Participation Loan Program: Immediate Participation	Participation Loan Program: Deferred Participation	Direct Loan Program
Number of Loans Approved	13,738	5,764	3,213	4,761
		Millions of dollars		
Loans Approved:				
Total Amount	639.5	299.3	143.9	196.3
Amount by SBA	538.3	235.1	106.9	196.3
Loans Disbursed:				
Amount by SBA	315.1	172.5	7.2	135.4
Amount by Participating Banks	137.5	47.9	89.6	—

Financial assistance from the SBA is restricted to small businesses by eligibility requirements which specify that the concern must not be dominant in its field of operation and that it not exceed a specified size. In manufacturing, the size limitation is set in terms of number of employees. This employment standard varies from one manufacturing industry to another, but in no case does it exceed 1,000. In nonmanufacturing industries, the size limitation is set in terms of dollar volume of business. Also the SBA statute sets a limit of $350,000 on the amount that may be loaned to any one borrower. As a result of these operating limits, most of the SBA loans have been of small size. Of the 13,738 business loans approved through December 31, 1958, 74.3 per cent of the number and 32.3 per cent of the total amount were for $50,000 or less.

The SBA is also authorized to make loans to assist business concerns and home owners affected by floods, storms, and other natural disasters, and to assist business firms in drought or excessive rainfall areas which have suffered economic injury as a result of disaster conditions. Through December 31, 1958, 8,130 disaster loans had been approved, amounting to $88,000,000; of this amount, approximately $72,000,000 had been disbursed. Although disaster loans are available to concerns of any size,

most of them are made to small concerns. Moreover, many of those made to individuals are known to have been used for business purposes.

IV

SBA Assistance in Obtaining Government Contracts

The Small Business Act provides that[23]

> the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for property and services for the Government (including but not limited to contracts for maintenance, repair, and construction) be placed with small-business enterprises, to insure that a fair proportion of total sales of Government property be made to such enterprises, and to maintain and strengthen the over-all economy of the nation.

The Small Business Administration is the principal spokesman within the federal government in connection with the administering and coordination of governmental efforts to assist small business firms to insure their receipt of a fair share of government contracts. Section fifteen of the Small Business Act[24] empowers the Small Business Administration and government contracting officers to set aside procurements for competition solely among small business concerns. The set-aside program is one of the principal methods by which the Small Business Act assists small firms in obtaining a fair share of government contracts. SBA representatives are assigned to major government purchasing offices, where they screen all proposed purchases to determine whether small firms can supply the items or services and where they evaluate the small business competition which can be expected. When the Small Business Administration representative determines that sufficient small business competition can be obtained, he recommends that the procurement be totally or partially set aside for competitive award to small business concerns. Procedures are available within the procurement agencies for review of refusal to accept the recommendations of the Small Business Administration representative.

The set-side program is growing constantly.[25] A table showing the agencies and departments cooperating with the Small Business Administration in carrying out the program, together with amounts of purchases set aside for small business concerns in fiscal year 1958 is given below.[26]

[23] 72 Stat. 384 (1958), 15 U.S.C.A. § 631 (Supp. 1959).

[24] 72 Stat. 395 (1958), 15 U.S.C.A. § 644 (Supp. 1959).

[25] In fiscal year 1956, the amount of purchases set aside was $497,678,432. The figures for fiscal years 1957 and 1958, respectively, are $744,335,298 and $1,062,454,031. Since the inception of the program until June 1958, 41,290 procurements, valued at $2,919,582,709, have been set aside for small business concerns.

[26]

Army	$436,999,812
Navy	381,226,811
Air Force	192,973,955
Department of Commerce	24,934,561
General Services Administration	13,591,673
Veterans Administration	6,609,353
Department of Agriculture	3,021,267
Department of Interior	1,774,149
Post Office Department	1,222,450

Complementing the set-aside program is the activity of Small Business Administration representatives designed to locate competent small business suppliers for those items or services for which small business competition has been lacking. Information obtained in connection with screening for possible set-aside action is used for this purpose. Where it is found that an item or a service could be supplied by small business firms, but there has been little or no small business competition in connection with that item or service in the past, SBA field offices attempt to locate competent small business suppliers of the item or service. This has the effect of expanding small business competition and broadening the industrial base, in addition to assuring a better price to the United States as a result of greater competition. It also increases the number and variety of items and services on which set asides for small business firms can subsequently be made.

In connection with its efforts to achieve maximum participation by small business concerns, the Small Business Administration maintains a facilities inventory. Small firms requesting assistance from the agency are requested to complete a questionnaire concerning their productive facilities and other related information. This information provides a record from which the Small Business Administration can ascertain the productive capacity of small business firms in a given area, and enables the agency to notify small business firms of prime contract or subcontract opportunities suitable to their facilities. It is also used to locate new sources for items or services on which competition is needed by Government purchasing offices. Further, the information is useful in connection with bid sets which the agency receives from many of the larger purchasing offices. By checking these bid sets against the facilities inventory, the agency is able to notify firms capable of supplying the item or service of procurement opportunities.[27]

Experience has shown that many firms have little or no idea of the nature of government procurement. In order to assist small business firms to compete effectively for government procurement, the Small Business Administration has instituted programs to bring government procurement requirements to the attention of small business concerns; it has also sought to clarify government procurement procedures. Small business concerns receive counseling on how to sell to the Government and information about the requirements of the various agencies. They are assisted in being listed on appropriate bidders' lists and in receiving bid sets for items or services which they are able to supply. The Small Business Administration publishes the *U. S. Government Purchasing and Specifications Directory,* which provides detailed information on items and services purchased by the Government, sources of specifications used by agencies in purchasing, steps to take in locating prime contract and subcontract opportunities, and other helpful data.

As part of this informational program and in order to bring its own programs to the attention of more small business firms, the Small Business Administration

[27] Approximately 39,000 firms are presently registered with the Small Business Administration. During fiscal year 1958, more than 32,000 referrals of opportunities to small business concerns have been made by the agency.

co-sponsors opportunity meetings. In fiscal year 1958, nineteen such meetings were held, with an estimated 12,375 small business owners and managers in attendance. At these meetings, through the media of talks by government purchasing officials, visual displays, sample bid sets, and other exhibits, those in attendance learned of government purchasing methods, prime contract and subcontract opportunities, and helpful government services. These meetings also featured exhibits by large prime contractors of items for which they welcome subcontracts. Purchasing agents were on hand at the meetings to discuss their requirements with small firms and to list firms on their bidders' lists for subcontract work and direct purchases.

The Small Business Administration assists small firms to solve problems regarding bids and specifications and helps to resolve difficulties between small firms and government procurement officials.[28]

Moreover, the SBA seeks to obtain copies of specifications from procuring agencies in time for small firms to submit a bid. The agency also reviews new and interim federal specifications received from the General Services Administration. Where the specifications appear to be too restrictive or discriminatory, the Small Business Administration recommends changes. In a number of cases, this has resulted in deletion or modification of specifications. The Small Business Administration also recommends new specifications or revisions in present specifications to enable small firms to compete by making their products eligible; and negotiations are held with a number of procuring agencies to accomplish this purpose.

The Small Business Administration also seeks to develop subcontracting opportunities for small business concerns. Due to a shift in the nature of Department of Defense purchasing, with its greater emphasis on missiles, aircraft, and other highly complex weapons purchased under the weapon-system concept, subcontracting opportunities are of increasing importance to small business concerns. The agency is intensifying its subcontracting program, tailoring it to the needs of small business firms under changing procurement conditions. The agency recently made available for use by its offices, as well as by the armed services, a directory entitled ***Missile Subcontracting***, which contains information regarding (1) items used in the production of missiles, (2) assembly, subassemblies, and parts of missiles, and (3) companies engaged in the production of missile subsystem components, assemblies, subassemblies, and parts. The agency also compiles data on firms which have requested assistance in obtaining subcontracts. Agency representatives contact prime contractors and large subcontractors to interest them in subcontracting to these firms.[29]

Closely allied to the new weapons requirements of the Department of Defense is the recently increased demand for research and development. The Small Business Act provides, in substance, that the Small Business Administration is empowered

[28] In fiscal year 1958, Small Business Administration field offices recorded almost 25,000 cases of procurement counseling and representation in behalf of small firms at purchasing offices. An additional 7,700 firms were helped to bid on specific procurements.

[29] In fiscal year 1958, Small Business Administration representatives made more than 3,000 of such calls and as a result, were able to refer approximately 6,500 opportunities to small firms.

to assist small firms (1) to obtain government research and development contracts, and (2) to obtain the benefits of government-sponsored research and development.[30] Further, the Act calls upon the Small Business Administration to provide technical assistance to small business concerns to achieve these objectives.[31] The Small Business Administration is presently developing programs to achieve these objectives.[32]

The Small Business Administration field offices counsel and guide small firms and individuals interested in research and development work and direct them to appropriate procurement officials. The agency has issued a management aid on *Research and Development Opportunities in the Federal Government*, which describes steps to be taken by those firms seeking research and development work with the Government, lists the types of research and development contracts contracted for by civilian agencies, and explains which offices should be contacted by interested small firms.

Although much of the activity of the agency in connection with procurement assistance is directed at developing bidding opportunities for the small business concern and informs the small business concern of such opportunities, the agency also furnishes more direct assistance. An outstanding activity in this regard is the issuance of certificates of competency.

The Small Business Act authorizes the Small Business Administration to certify that small business concerns or small business defense production pools are competent, with respect to financial means and productive capacity, to perform specific government contracts.[33] This determination by the agency is binding on the procuring authority in so far as financial and technical capabilities of the firm are concerned. The certificate of competency offers a method of appeal for a small business concern which—although low bidder on a procurement—has been rejected for lack of financial and productive capacity. After issuance of the certificate, agency representatives maintain a continual follow-up to assure that the contract is successfully performed.[34]

In summary, the Small Business Administration, in carrying out the mandate of Congress to assist and counsel small business concerns in the area of government procurement, has instituted various programs. Some of these are mainly informative in nature—providing information both to other government agencies and to small business concerns. Other activities are aimed directly at achieving more small business participation in particular government procurements.

[30] 72 STAT. 391 (1958), 15 U.S.C.A. § 638(b)(1) (Supp. 1959).
[31] *Id.* § 638(b)(3).
[32] The need for such assistance to small business concerns is indicated by the fact that only 3.7 per cent of the value of research and development contracts awarded by the military services in fiscal year 1958 was received by small business concerns.
[33] 72 STAT. 389 (1958), 15 U.S.C.A. § 637(b)(7) (Supp. 1959).
[34] In fiscal year 1958, certificates of competency were issued on contracts amounting to more than $26,000,000. Since the inception of the agency in August 1958, certificates have been issued on contracts having a total value of $64,000,000.

V

SMALL BUSINESS INVESTMENT ACT

The Small Business Investment Act of 1958[35] was signed by President Eisenhower and became effective on August 21, 1958. The stated purpose of the Act is to improve the national economy in general and the small business segment thereof in particular by establishing a program to supplement the presently inadequate sources of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization.[36]

Congress has directed that the program be conducted with a maximum participation of private financing. Further, it is the expressed intention of Congress that any financial assistance provided by the Government in this program shall not cause a substantial increase in unemployment in any area of the country, through industry pirating or otherwise.[37]

This legislation is designed to fill a gap in small business financing. Equity capital and long-term loans for growth and development purposes have never been readily available to small business. Commercial banks furnish short and intermediate-term loans, but not venture capital and long-term credit. Existing institutions which could provide venture capital are not able to assist smaller firms, since the cost for public sale of securities is disproportionately high to small business issuers. The Small Business Administration, under its regular lending program, can assist small business concerns with intermediate-term loans, but cannot provide the long-term funds needed for growth and development. As a result, there has been no institutional source to which small business could turn to meet its capital needs. It is this so-called institutional gap which the Small Business Investment Act of 1958 is designed to fill.

Under the Small Business Investment Act, the Small Business Administration has two main functions:

1. The Small Business Administration will license and regulate small business investment companies operating under the Act. The agency is empowered to charter private small business investment companies in states where such organizations cannot be organized or operate effectively under state law. These small business investment companies are to be devoted entirely to financing small business enterprises.

2. The second main function under this Act is to help these investment companies obtain financing by purchasing their debentures—and by making loans to them. Also, the Small Business Administration can lend money to existing state and local development companies that meet certain standards of operation where these loans will, in turn, be used to provide equity capital and long-term loan funds for small business concerns.

[35] 72 STAT. 689, 15 U.S.C.A. §§ 661-87 (Supp. 1959).
[36] § 102, 72 STAT. 689, 15 U.S.C.A. § 661 (Supp. 1959).
[37] *Ibid.*

The new legislation provides the Small Business Administration with a revolving fund authorization of $250,000,000 to make these loans, and approximately $50,000,000 of this authorization has been budgeted for the remainder of the present fiscal year ending June 30, 1959.[38] The SBA will not be providing long-term financing to individual small businesses under this new legislation. Instead, it will assist in the creation of private small business investment companies, and will make loans to them and to state and local development companies. These companies, in turn, will make long-term financing available to individual small concerns, or provide them with equity-type financing. Thus, the federal government will have no direct relationship with small concerns under this program. The responsibility for investing in small business concerns, or making long-term financing available to them, rests with the small business investment companies.

The Act sets forth only basic and broad provisions and relegates to the Small Business Administration, as the administrative agency, the responsibility for establishing details and procedure. The SBA will select and license private corporations which will be chartered for the specific purpose of providing funds to small business concerns through the purchase of convertible debenture bonds of such concerns and the disbursement of long-term loans to such concerns. The activities of such corporations will be subject to regulations prescribed by the SBA, and such corporations will be examined by the SBA and will make reports as and when requested by the SBA.[39]

A small business investment company which has been licensed by the SBA will thereupon become eligible for financial assistance from the SBA, as provided under the Act, and will be eligible for discretionary exemptions by the Securities and Exchange Commission under the Securities Act of 1933[40] and the Trust Indenture Act of 1939,[41] as well as an automatic exemption from the three-to-one asset to borrowings ratio required under the Investment Act of 1940.[42] The Securities and Exchange Commission has issued its own regulations with respect to the discretionary exemptions available under these Acts.[43] In addition, the company will become eligible for tax benefits specified under the Technical Amendments Act of 1958.[44] Stockholders of such corporations are eligible also for tax benefits specified under the latter Act.

Section 57 of the Technical Amendments Act of 1958 contains three specific tax features amending the Internal Revenue Code of 1954. First, it provides that these investment companies are to be allowed an ordinary loss deduction, rather than a capital loss deduction, on losses realized on the convertible debentures (including stock received pursuant to the conversion privilege) acquired in connection with

[38] § 202(a), 72 Stat. 690, 15 U.S.C.A. § 633(d) (Supp. 1959).

[39] The Regulations under the Small Business Investment Act were promulgated on Dec. 1, 1958. See 23 Fed. Reg. 9383 (Dec. 4, 1958).

[40] 48 Stat. 74, 15 U.S.C. §§ 77a-77aa (1952).

[41] 53 Stat. 1149, 15 U.S.C. §§ 77aaa-77bbbb (1952).

[42] 54 Stat. 789, 15 U.S.C. §§ 80a-1-80a-52 (1952).

[43] Regulation E.

[44] See pt. II *supra*.

the supplying of long-term equity-type capital for small business concerns. This loss deduction includes losses due to worthlessness, as well as those arising from the sale or exchange of the security. Second, taxpayers investing in the stock of the proposed investment companies also are to be allowed an ordinary loss deduction, rather than a capital loss allowance, on losses arising from the worthlessness, or from the sale or exchange of such stock. The third tax feature of this amendment provides that these investment companies are to be allowed a deduction for 100 per cent of the dividends received from a taxable domestic corporation, rather than eighty-five per cent deduction generally allowed corporate taxpayers.

Licensees ordinarily will be subject to the personal holding company tax imposed by section 541 of the Internal Revenue Code of 1954[45] unless at no time during the last half of its taxable year more than fifty per cent in value of its outstanding stock is owned by or for any five or less individuals. Internal Revenue Service will issue regulations covering the tax benefits available to both a small business investment company operating under the Act and the investors therein.

As indicated, only small business concerns can be aided by the investment companies. The Small Business Investment Act regulations provide a definition of what constitutes a small business concern for the purposes of the Act.[46] This definition, it is hoped, will permit ready indentification of the bulk of such concerns. The basic concept that a small business concern is one which is independently owned and operated and not dominant in its field of operations is retained. A wholly-owned subsidiary of another concern, or one which is under the control of another concern, is not prima facie independently owned and operated. A concern whose stock is listed on an exchange or traded over the counter is not prima facie small. Nor is a concern which has obtained public financing of over $300,000 within three years. A noncorporate entity or one whose stock does not have a public market is not small if its total assets, together with those of all its affiliates, amount to over $5,000,000, or if its total income after taxes, including affiliates, has averaged over $150,000 per annum during the past preceding three years. However, any concern may apply to the SBA for a specific determination and certification as a small business concern.

Parties interested in the formation and licensing of a small business investment company for operation under the Act may file with the SBA a proposal or preliminary application on a form which can be obtained from the Washington or any regional or field office of the SBA. This proposal is a detailed document and should be given thorough and intelligent consideration in its preparation in order to justify serious consideration by the SBA. Among other matters, it must include the proposed name and operating territory of the prospective licensee. It must include copies of the proposed articles of incorporation and by laws of the proposed licensee, justification for the establishment of such company as a licensee in the proposed operating terri-

[45] See INT. REV. CODE of 1954, §§ 541-547; 26 C.F.R. 1.541-1-1.541-7.
[46] § 107.103-1 (Definitions).

tory, proposed operating plans and policies, details with respect to the proposed capitalization of the company, the identification and background of proposed officers and directors of the company, and a plan for the expansion of the financial resources of the company as a licensee through the sale of its stock to private investors.

In considering whether to license an investment company, the SBA will give consideration to the need for financing by such company or small business concerns of the type the prospective licensee intends to assist. The character and ability of the proposed management to conduct the activities of the company so as to accomplish the purposes of the Act will be a controlling factor also in the licensing of a company.

Upon receipt of a proposal, the Small Business Investment Division will register the same and conduct such investigation as it deems appropriate. After consideration of the proposal, such applicants will be notified by the SBA whether the proposal, on its face, may justify further consideration of the issuance of a license to the company dealt with in the proposal. If so, the SBA will authorize the parties who filed the proposal to proceed with all action necessary to qualify their company for execution of a formal application and final consideration by the SBA as a licensee. Within ninety days from the date of such notice, the company should execute and submit to the SBA the formal application on a form to be supplied by the SBA, requesting the issuance of the license. Among other matters, the application will contain the offer of the company to conduct its activities under regulations prescribed by the SBA. After submission of the formal application, the SBA will issue a license if all requirements have been met.

Section 107.301-1 of the regulations under the Act sets forth the specific powers and authority which the charter of a licensee can contain. The charter must be limited to such powers, since the activities of a small business investment company operating under the Act must be devoted exclusively to the specific functions set forth in the Act. For instance, the charter of a licensee will permit the company to provide capital funds to small business concerns only through the purchase of convertible debentures. Only long-term loans, as defined by the SBA, can be made to small business concerns. Such loans will carry a maturity of not less than five years. The charter of a licensee will require that its operations be conducted in accordance with and subject to regulations prescribed by the SBA. While the operations of an investment company may be confined by charter or license to a specified geographical area, the company may do business with small business concerns located beyond such area.

The charter of a licensee must be obtained from the state or territory in which it operates, or if it operates in more than one state or territory, the charter will be obtained from any state or territory within the area of its operations. A licensee must be authorized or able to conduct its activities, as a domestic or foreign corporation, in the entire area in which it proposes to operate, in accordance with the provisions of its charter, the Act, and regulations prescribed by the SBA thereunder.

The SBA will consider the issuance of a federal charter only if the parties are unable to obtain from a state or territory a charter containing the provisions required by the Act and SBA regulations, or if such a charter is available but restricted in such a manner that the company cannot operate in accordance with the purposes of the Act. An opinion of counsel and brief in support thereof dealing with reasons why a state or territory charter is unavailable must be submitted with a request for a federal charter.

The Act requires each licensee to have a paid-in capital and surplus equal to at least $300,000.[47] However, the SBA can purchase subordinated debentures of a company up to $150,000, which shall be deemed a part of the capital and surplus of such companies for the purposes of the minimum capitalization required by the Act and for other stated purposes. Interest for such funds will be charged at the rate of five per cent per annum, and such obligations must have a stated maturity of not in excess of twenty years. Amortization must commence no later than the beginning of the second half of the term thereof.

Shares of stock of any class in a licensee can be issued by the licensee only in consideration for the simultaneous payment of cash to the licensee or as stock dividends. No shares may be issued for services, property, or any other noncash consideration.

SBA regulations require a licensee to make a full and complete disclosure of all matters to its prospective investors and shareholders.[48] The licensee must submit to its shareholders and to the SBA an interim report containing financial statements covering the operations of the first six months of each fiscal year, and shall submit at the end of each fiscal year a report containing financial statements for the year and an opinion thereon by an independent certified public accountant based on an audit conducted in accordance with generally accepted auditing standards.

In addition to the subordinated debentures of a licensee which the SBA is authorized to purchase, the SBA can lend operating funds to a licensee up to fifty per cent of its paid-in capital and surplus, provided such funds are not available from other sources. Interest upon such loans will be at the rate of five per cent per annum, with maturities up to twenty years. Such loans can provide funds for new investments and loans by a licensee. These loans also can be a source for funds to protect the interests of a licensee in its investments and loans, until capital is obtained from private sources in sufficient amounts to provide cash for such purposes. By SBA regulation, the ratio of the total amount of outstanding indebtedness of a licensee to its paid-in capital and surplus cannot exceed four to one.[49]

Simultaneously with the disbursement by the SBA of any funds to a licensee, the executive officer and at least three members of the board of directors of the licensee must deliver a certificate to the SBA reciting that the licensee has not violated the Act, its charter, its license, or any regulations issued under the Act; that the capital of the

[47] 72 STAT. 692, 15 U.S.C.A. § 682(c) (Supp. 1959).

[48] § 107.302-3.

[49] §107.303-1.

licensee is not impaired; that the licensee will employ such funds within thirty days after receipt thereof in connection with the purchase of convertible debentures from or the making of long-term loans to small business concerns; and, that such funds will not be employed for any purpose which would cause a substantial increase in unemployment. The names of attorneys, agents, or others representing the licensee before SBA and any fees paid such parties must be disclosed. Further, the licensee must agree not to employ, within two years after disbursement of the funds, any person serving as an officer, attorney, agent, or employee of the SBA in a position involving discretion with respect to the granting of such financial assistance.

A licensee must maintain an unimpaired capital at all times. By SBA regulation an impairment will exist when, with the assets and liabilities (including debentures purchased by the SBA under section 302(a) of the Act)[50] evaluated by sound accounting principles, the earned surplus deficit exceeds either the paid-in surplus or fifty per cent of the combined capital stock and paid-in surplus.

As indicated, a primary function of a small business investment company licensed for operation under the Act will be to provide a source of funds for the purchase of debenture bonds issued by small business concerns. Such funds must be used for the sound financing of the operations of and the growth, expansion, and modernization of such concerns. These bonds will be callable on any interest payment date, upon three months' notice, at the face value thereof plus accrued interest, and shall contain an option for the original holder, or any holder in due course thereof, to convert the same into stock of the small business concern, at any time up to and including the effective date of any call thereof by the small business concern.

Debenture bonds will be convertible into the number of shares of stock of such small business concern of an agreed type representing a total value equal to the face value of the bonds being converted. The value per share of said stock is required by the Act to be the sound book value thereof determined at the time of the issuance of the debentures. In computing such value, the regulations permit consideration of all pertinent factors, including the actual value of the assets of the small business concern and the relationship of the earnings of such concern to its invested capital.

The sale and purchase of such bonds will result from and be based upon the private negotiations between the small business concern and a licensee. This is in line with the principle stated earlier that the financial assistance to small business concerns made available under the Act will come from the privately owned and operated small business investment companies, and not from the Government. The SBA will not participate in the dealings between a small business investment company and a particular small business concern. The basic responsibility of the SBA under the Act is to establish and regulate the operations of small business investment companies in a manner which will accomplish the purpose of the Act through the stimulation and supplementation of private capital and loan funds for small business concerns. That is not to say that the SBA will not have an interest in small business

[50] 72 Stat. 692, 15 U.S.C.A. § 682(a) (Supp. 1959).

concerns seeking and receiving benefits under the Act; its interest will be reflected in the regulation of the investment companies.

As a matter of initial regulation, the SBA has provided that the rate of interest to be stated in such bonds cannot exceed the maximum rate applicable to such transactions under local law. Should no legal limit exist, the rate may be established by the licensee, but subject to approval by the SBA.

The Act requires a small business concern that has been aided by a small business investment company through the purchase of convertible bonds to purchase capital stock of the licensee, at an agreed price, in an amount equal to not less than two nor more than five per cent of the amount of capital provided.[51] The SBA has regulated this on a sliding scale basis, namely, two per cent up to $50,000, three per cent up to $100,000, and five per cent thereafter.[52]

In addition to the purchase of such convertible debentures, small business investment companies operating under the Act will also provide long-term loan funds to small business concerns for the sound financing of the operations of and the growth, expansion, and modernization of such concerns. By regulation, the SBA has provided that the maturity of any such loans must be not less than five years, unless the loan is for the purpose of protecting the interests of a licensee in an existing long-term loan or for purchase of convertible debentures or stock.[53] It is intended that the Act and the regulations thereunder provide that such loans cannot give any right in a licensee to acquire stock or any other proprietary interest in the borrower, except through the medium of collateral security.

These long-term loans may be made by a licensee directly or in co-operation with other lending institutions through agreements to participate on an immediate or deferred basis. The initial maturity of such loans is limited to not in excess of twenty years, although a licensee may extend or renew the same for additional periods up to ten years if necessary for the orderly liquidation of the loan. The loans must be of such sound value, or so secured, as reasonably to assure repayment. By regulation, the SBA has provided that the rate of interest for a licensee's share of any such loan shall not exceed any applicable maximum rate.[54] If no maximum rate exists, the maximum rate of interest for a licensee's share will be determined by the SBA. As in the case of the purchase of convertible debentures, long-term loans will result from negotiations between a licensee and a small business concern.

Without prior written approval from the SBA, a small business investment company operating under the Act cannot hold aggregate obligations and securities of a particular small business concern in excess of twenty per cent of the combined capital and surplus of such licensee. Any stock of a small business concern shall be evaluated for such purpose on the basis of the agreed value thereof at the time of acquisition.

[51] 72 STAT. 693, 15 U.S.C.A. § 684(d) (Supp. 1959).
[52] § 107.304-1(h).
[53] § 107.305-1(b).
[54] § 107.305-1(e).

The SBA has provided that without its prior approval, a licensee will not be permitted to purchase convertible debentures of, or make a loan to, an officer, director, or owner of ten or more per cent of the stock of such licensee, or any relative thereof, or to any company in which such officer, director, owner, relative is an officer or director, or owns ten or more per cent of the stock, or is a partner.

Any funds of a licensee not reasonably needed for current operations may be invested only in direct obligations of, or obligations guaranteed as to principal and interest by, the United States Government. Hence, a licensee is limited in its investments to the purchase of convertible bonds of small business concerns and the making of long-term loans to them with interim investments, when its funds cannot be employed for such primary purposes, in obligations of, or those guaranteed by, the Government.

A potent medium for insuring compliance by small business investment companies with the provisions of the Act and regulations issued thereunder, will be the exercise by the SBA of its power of examination provided under the Act. Each licensee is subject to examination by the SBA with respect to any and all matters and at such times as may be determined by the SBA. It will be through the medium of examinations that the SBA will continually check whether a licensee is operating within the investment, loan, and other policies and plans which justified and induced the SBA to license the company initially.

Each licensee will be required also to submit reports to the SBA at the end of each six months' period of operation. Such reports will set forth in detail the current financial condition of the licensee and will include a review of the activities of the licensee during the period involved, with a statement and evaluation of assets acquired during such period. The SBA can call for interim reports covering such matters as it may determine.

Another feature of the Small Business Investment Act of 1958 is the assistance to be provided to state and local development companies. For identification purposes, SBA loans authorized under section 501 of the Act[55] will be referred to as "501 loans," and those authorized under section 502 of the Act[56] as "502 loans."

"501 loans" are limited to state development companies, and the total 501 loans outstanding at any one time to any one state development company cannot exceed the total outstanding borrowings of such company from other sources. Unless waived by the SBA, the rate of repayment of a 501 loan will be at no lesser rate than other debts of the development company. 501 loans will bear interest at five per cent per annum and can run for periods up to twenty years.

Also, unless waived by the SBA under circumstances which would justify such action, 501 loans will be secured on a basis equal with other funds borrowed by the company after August 21, 1958, the date of enactment of the Act. This equality, however, may not require that all of an SBA loan be secured to the maximum degree

[55] § 501, 72 STAT. 696, 15 U.S.C.A. § 695 (Supp. 1959).
[56] § 502, 72 STAT. 697, 15 U.S.C.A. § 696 (Supp. 1959).

that every other loan of the company is secured. By way of example, if the development company has borrowed an outstanding $20,000, of which $10,000 is secured by a first mortgage and $10,000 is unsecured, and it borrows $15,000 from the SBA, $10,000 of this amount must be secured by a first mortgage, and $5,000 of this amount may be unsecured.

A state development company may use the proceeds of 501 loans to stimulate and supplement the flow of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization and which are not available in adequate supply. Maximum participation of private financing sources must be obtained. Further, any financial assistance provided by the SBA must not result in a substantial increase of unemployment in any geographical area.

"502 loans" can now be made by the SBA to both state and local development companies, but the authority for such loans to local development companies expires on June 30, 1961. Such loans may provide funds to a development company only for the purpose of financing plant construction, conversion, or expansion, including the acquisition of land, to assist an identifiable small business concern in connection with a sound business purpose. Under SBA regulations, 502 loans may not be made to assist eleemosynary institutions; to aid the press, radio, or television; or to assist gambling or a small business concern which receives a substantial portion of its income from the sale of alcoholic beverages.

To obtain a 502 loan, a development company must show that a participation therein by another lending institution is not available. If the development company or the small business concern can obtain such financial assistance elsewhere, 502 loans will not be made. Interest on the SBA's share of a 502 loan will be 5½ per cent per annum. The maturity of such loans cannot exceed ten years plus such period as may be required for completion of construction, conversion, or expansion. Such loans, however, can be extended or renewed for an additional 10-year period to aid orderly liquidation. All 502 loans must be secured and may not exceed $250,000 for each identifiable small business concern.

CAPITAL FOR SMALL BUSINESS: SOURCES AND METHODS

BERNARD D. CAHN*

The recurrent debate during the past quarter century on the financial needs of the small business concern has led finally to the adoption of the Small Business Investment Act of 1958,[1] which establishes another potential source of loans and equity funds for some small business concerns. The Senate Committee on Banking and Currency, in its report,[2] supported its recommendation of the statute by references to testimony and conclusions of witnesses and others that small business has unnecessarily great difficulty in obtaining term loans and equity capital.[3]

The Federal Reserve System, however, in its exhaustive study of the financing problems of small business,[4] found it difficult to arrive at definitive answers to the questions involved. Its report contains papers setting forth conflicting views on whether the small businessman does, indeed, lack adequate sources of capital,[5] and concludes:[6]

As suggested earlier, perhaps it will never be possible to determine, on the basis of

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[1] 72 STAT. 689, 15 U.S.C.A. § 633 (Supp. 1959).

[2] Senate Committee on Banking and Currency, *Report*, S. REP. No. 1652, 85th Cong., 2d Sess. (1958) [hereinafter cited as SENATE REPORT].

[3] Documentation included U.S. BUREAU OF CENSUS, DEP'T OF COMMERCE, SURVEY OF REPORTS OF CREDIT AND CAPITAL DIFFICULTIES BY SMALL MANUFACTURERS (1935) (based on replies to questionnaires by 6,158 firms employing between 21 and 250 employees); *Hearings before the Senate Select Committee on Small Business*, 78th Cong., 1st Sess. (1943); RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE ON ECONOMIC DEVELOPMENT, MEETING THE SPECIAL PROBLEMS OF SMALL BUSINESS, A STATEMENT ON NATIONAL POLICY (1947); *Hearings before the Senate Committee on Banking and Currency on the Small Business Act of 1950*, 81st Cong., 2d Sess. (1950); McHugh and Ciaccio, *External Financing of Small and Medium-Size Business*, Survey of Current Business, Oct. 1955, p. 15. *Cf.* CHARLES O. HARDY & JACOB VINER, REPORT ON THE AVAILABILITY OF BANK CREDIT IN THE SEVENTH FEDERAL RESERVE DISTRICT (1935); Stoddard, *Small Business Wants Capital*, 18 HARV. BUS. REV. 265 (1940); Weissman, *Raising Capital for Small Business*, Challenge Magazine, Jan. 1958, p. 8; Johnson, Scanlon, Friend, & Shapiro, *Shortage of Surplus of Funds to Finance Business*, 12 J. FINANCE 264 (1957); Murphy, *Big Worry for Small Business*, Fortune Magazine, July 1957, p. 120, which arrive at the same general conclusions. *But see* Schweiger, *Adequacy of Small Business Financing: Another View*, in FEDERAL RESERVE SYSTEM, 85th CONG., 2d SESS., FINANCING SMALL BUSINESS 124 (Comm. Print 1958) [hereinafter cited as FEDERAL RESERVE REPORT]. Loucheim, *The Problem of Long Term and Equity Capital*, 11 LAW & CONTEMP. PROB. 248 (1945); Donham, *Whither Small Business*, 35 HARV. BUS. REV. 73 (1957), which cast doubt on some of the conclusions in the *Senate Report*.

[4] FEDERAL RESERVE REPORT.

[5] *Compare* Kaplan & Banner, *Adequacy of Small-Business Financing: One View*, in FEDERAL RESERVE REPORT 107, *with* Schweiger, *supra* note 3. Only the former paper supported and was cited in the *Senate Report*. See SENATE REPORT 5.

[6] FEDERAL RESERVE REPORT 17-18.

statistical evidence alone, the nature and extent of existing imperfections and unfilled needs in the financing of small business. The notion of need itself is elusive and to a certain degree unverifiable. . . . There is some evidence in the background studies, however, that there is an unfilled margin, perhaps a rather thin one, between the volume of funds available to small concerns in general, and to new firms in particular, and the volume that could be put to use without prohibitive risk. It is also possible that this margin varies with changes in credit and business conditions.

Perhaps the best help for small business at the present stage of economic development would be the maintenance of an expanding, reasonably stable economy, with personal incomes rising. This is not inconsistent with the desirability of broadening the financial facilities available to small business, but it suggests that the net contribution to small business to be expected from such facilities would be relatively minor compared with the more generalized effects of the maintenance of all-around business prosperity.

The position of the small businessman in our national structure poses not only economic problems, but political and sociological ones, as well; and the differences in conclusion may be traceable, in part, to the differences in function and purpose of the various participants in the debate. To the small businessman, however, faced with the practical problem of raising capital to improve his position, the national debate may be confusing. His thinking, which relates to a specific fact situation, may be unduly influenced by the broad conclusions of legislators, economists, and others, stated in terms of the national problem. Many businessmen have avoided the recognized capital markets because of lack of understanding of facilities available to them; others, previously unable to raise capital, may now have the mistaken impression that the new Act will permit them to accomplish more than the facts warrant.

Small business has had and will continue to have problems in the financial field, but external capital (*i.e.*, capital not produced by the company's earnings and excluding ordinary trade and bank credit) is available on a competitive basis to a substantial number of growth companies in the small business category. As in other fields, the smaller enterprise must overcome its competitive disadvantage, resulting in part from size, by appropriate inducements.

I

Size of the Acceptable Unit

The size and acceptability of the unit must, for investment purposes, be measured in terms of several dimensions: management, size of assets, earnings and net worth, nature of industry and business, earnings trends and growth potential, market factors, nature of the capital desired, and others. A private investor may have one set of standards; an institutional lender, another;[7] and the public markets, a third. There is a close relationship among them, but each is independent. And the businessman must know all three in order to arrive at an informed decision on his specific problem.

At the lowest end of the scale are the businesses generally too small to interest an

[7] See, *e.g.*, size categories established by Federal Reserve Banks, depending on the industry. FEDERAL RESERVE REPORT 161.

independent investor. Such units constitute eighty-two per cent or more of all the businesses in the country;[8] they are, in substance, no more than jobs for their owners. The corner retail store, the small stamping plant, the gas station, and other similar enterprises usually fall in that category. Almost all of such businesses are financed by personal resources and those of friends and relatives. Insurance policy loans are a significant source of funds to such small entrepreneurs. At the other end of the scale, for purposes of this analysis, is the small business approaching intermediate size, which has attributes sufficiently interesting to investors to be able to do public or institutional financing with little difficulty. In between the two extremes of the small business community are various indistinct dividing points separating the units acceptable for investment of external capital from those that are not able to raise external capital from private investors, institutions, or public investors.

Surveys of available data with respect to public and private investment support the following conclusions:

1. It is difficult, if not impossible, to generalize on the size and nature of a business that can attract funds from individual or venture-capital sources. Venture-capital investors usually seek large capital gains. Such gains are not dependent on size, but on the nature of the business.

2. Surveys of leading life insurance companies indicate that institutional loans are available in amounts as low, at times, as $100,000 or less. Borrowers with net worths above the $250,000-350,000 level (usually with total assets exceeding $1,000,000), meeting certain standards of soundness and growth potential, receive serious consideration for institutional loans. The determination of a good risk, however, will depend on more than net worth or asset size.

3. Equal difficulty is experienced in attempting to describe the company sufficiently large to raise funds via the public offering route. Here, again, growth potential, earnings record, calibre of management, nature of the business, and many other factors affect the ability of a company to enter the financial markets. The timing of the offering is also of some importance. Generally speaking, however, a company with minimum net earnings after taxes of $100,000 to $150,000, a net worth of $400,000 to $500,000, a record of growth and further growth potential, in an attractive field, and with acceptable management would be able to make a public offering of securities. Total assets and sales are usually only minor measurement standards.

II

PROBLEMS AFFECTING FINANCING OF THE SMALL BUSINESS

A. Competition for Funds

The economic history of the United States has been marked by increasing amounts of capital invested per worker employed, with increasing productivity per worker and

[8] See ROY A. FOULKE, PRACTICAL FINANCIAL STATEMENT ANALYSIS 151 (4th ed. 1957).

a rising standard of living.[9] The amount spent on producers' durable equipment has quintupled in twenty-five years. Although other factors have contributed to stimulate this increase, high wage costs and competition are the principal spurs to more plant investment. The competition for savings has been increasingly keen in recent years, and present prospect is for continued high money rates and tight money markets. In a dynamic growing economy, the needs of entrepreneurs may exceed available capital resources.[10] At best, there will be an unsatisfied demand, with all businesses—small, medium, and large—competing for the investors' funds. Increasing concentration of savings in the hands of institutions, investment trusts, and other similar investors means that small business, more and more, must meet recognized competitive standards of performance, management, and growth potential in order to raise new capital.

B. Approach to the Market

The popular literature on the financial woes of the small businessmen is replete with stories of the frustration and disaster which await the small businessman who ventures alone into the capital market.[11] Undoubtedly, some of the frightening examples result from lack of experience. The financial market is a complex mechanism which includes many different kinds of financial houses, institutions, private investors, and other sources of capital and term loan funds. Each has its own role to play, and that role must be understood. Contact with the right source of funds requires study of the company's needs, as well as knowledge of the ramifications of the market place.

C. Capital Structure

At best, the design of a proper capital structure is a difficult, complex task. Various kinds of debt and equity securities are available for the company's purposes: secured, unsecured, and subordinate bonds and debentures, convertible and nonconvertible, refundable and nonrefundable, with and without sinking funds, and with a variety of terms and conditions. Different classes of stock, with a host of special provisions to choose from, may be designed to meet the issuer's financial problems.[12] Fashions and fads in securities must be taken into account.[13] Institutions and underwriters (and sometimes knowledgeable private investors) will insist upon the observance of certain standards of interest coverage, and ratios of debt to net worth and working capital. No general formulae are available; each case requires a tailor-made structure.

[9] *Cf. Financing Your Company*, address by Andrew Overby, Vice President, First Boston Corporation, and former Assistant Secretary of the Treasury, before the Third Annual Industrial Economics Conference, Los Angeles, Cal., reported in Commercial and Financial Chronicle, Jan. 23, 1958, p. 1.

[10] See FEDERAL RESERVE REPORT 19.

[11] *Cf.* Murphy, *supra* note 3. The constant reference to the difficulties of the small businessman in meeting financial problems has apparently had an effect on the thinking of businessmen who require financing. Surveys indicate that many who require financing do not seek it because they believe they will not be able to obtain it. See FEDERAL RESERVE REPORT 17.

[12] *Cf.* Mendel, *Recent Financing Patterns and Their Derivation*, Bus. Law, July 1956, p. 117; LOUIS O. FOSTER, CORPORATE DEBT AND THE STOCKHOLDER (1956).

[13] See 2 ARTHUR S. DEWING, FINANCIAL POLICY OF CORPORATIONS 1029 (5th ed. 1953).

The design of a proper capital structure frequently is complicated because of prejudices and misunderstandings of the small businessman. Almost without exception, capital sources report that the small businessman insists upon raising capital in the form of term loans, whereas his business usually requires equity funds.[14] The objections of the businessman often are related to (1) fear of loss of control (with consequent restrictions on emoluments as well as freedom of decision), and (2) reluctance to dilute earnings. Such objections may be based on misconceptions. The institutional lender and the reputable public offering underwriters are interested in the continuance of competent management and control. They seek to perpetuate it rather than to undermine it. Furthermore, a sufficient distribution of securities to the public permits control by management with substantially less than fifty-one per cent ownership. Finally, control positions can be preserved in a number of ways which will assure even the most apprehensive that he will not be unseated.

The objection based on earnings dilution may also be ill-founded. If the new capital is well used, it should return a fair profit per share, so that the profit position of the owner is not diluted, but is enhanced.[15] The difference in interest income available to the investor in connection with an investment in a small business usually does not compensate him adequately for the risk involved. He looks to the small company primarily for growth potential and capital gain. The small businessman who would expand must determine to part with some equity if he is to do the type of financing necessary for his own growth and to prevent stagnation or even deterioration.[16] He must recognize that usually a smaller share in a larger enterprise may be more beneficial than complete ownership of a company impeded by lack of adequate financing.

D. Earnings and Growth Potential

Among knowledgeable investors, there is the impression that small businesses, as a group, are more volatile in earnings from year to year, and not more profitable per dollar of investment, than larger, well-established enterprises. The earnings data in table one indicate that for most of the past two years, earnings of the smaller businesses have been below average.[17]

The data do indicate greater volatility in the smaller categories. But no clear conclusions emerge in comparing profitability per dollar of investment. The above data are, in fact, averages whereas the growth company is an above-average prospect, almost by definition. Also, the accounting practices of the small businessman may not be as accurate as those of his larger competitors. Furthermore, salaries of the

[14] In the insurance survey described below, many of the replying insurance companies stated that the insistence of undercapitalized borrowers on loans instead of equity capital funds constituted, in many cases, an obstacle to an effective financing program. *Cf.* FEDERAL RESERVE REPORT 13; Donham, *supra* note 3.

[15] See Weaver, *Equity Financing for the Small Firm*, 34 HARV. BUS. REV. 91 (1956).

[16] Some executives point out that failure to grow and keep pace with competition may lead to ultimate failure. *Cf.* Katona, *How Business Meets Money Needs*, Nation's Business, Dec. 1957, p. 32.

[17] Based on the Quarterly Financial Reports published by the FTC and the SEC.

TABLE I

ANNUAL RATES OF PROFIT ON STOCKHOLDERS' EQUITY BY ASSET SIZE (PER CENT)

Asset Size	Before Federal Income Taxes										
	Q1 1956	Q2 1956	Q3 1956	Q4 1956	Q1 1957	Q2 1957	Q3 1957	Q4 1957	Q1 1958	Q2 1958	Q3 1958
All asset sizes	23.8	24.2	20.2	22.3	22.5	21.6	19.1	16.8	12.9	13.9	15.9
Under $250,000	17.3	24.0	25.2	13.0	15.6	19.4	18.2	5.5	1.5	9.2	16.7
$250,000 to $999,999	18.9	22.1	23.0	12.8	15.7	19.2	20.4	7.4	7.6	12.4	16.3
$1,000,000 to $4,999,999	21.4	21.5	21.4	18.9	18.8	19.7	18.7	12.2	8.9	13.0	16.8
$5,000,000 to $9,999,999	22.2	22.5	21.3	19.5	18.0	21.0	19.7	14.8	11.9	13.9	17.8
$10,000,000 to $49,999,999	22.6	24.5	22.5	23.3	21.1	21.4	19.7	16.8	12.4	14.1	16.2
$50,000,000 to $99,999,999	23.4	24.2	23.0	22.5	22.0	21.4	20.7	17.5	14.3	14.9	17.9
$100,000,000 to $249,999,999	24.1	24.5	19.9	24.1	22.6	22.0	20.1	19.1	15.0	16.7	18.0
$250,000,000 to $999,999,999	25.4	25.7	20.3	23.9	22.1	21.2	19.4	17.7	13.9	15.3	17.8
$1,000,000,000 and over	25.9	24.4	16.6	24.0	27.3	23.1	17.7	19.3	14.3	12.3	12.3

Asset Size	After Federal Income Taxes										
	Q1 1956	Q2 1956	Q3 1956	Q4 1956	Q1 1957	Q2 1957	Q3 1957	Q4 1957	Q1 1958	Q2 1958	Q3 1958
All asset sizes	12.5	13.0	11.0	12.6	11.9	11.6	10.5	9.8	6.8	7.8	9.0
Under $250,000	10.3	15.6	15.3	5.8	8.4	11.1	11.0	0.7	-3.0	4.7	10.3
$250,000 to $999,999	9.5	11.5	11.7	5.8	7.5	10.0	10.1	2.4	2.1	5.7	8.9
$1,000,000 to $4,999,999	10.6	10.4	10.7	9.1	8.9	9.6	9.1	5.4	2.9	5.9	8.0
$5,000,000 to $9,999,999	10.7	10.9	10.4	9.8	8.4	10.1	9.7	7.3	4.9	6.4	8.8
$10,000,000 to $49,999,999	11.1	12.2	11.1	11.8	10.2	10.5	9.8	8.7	5.8	7.0	8.0
$50,000,000 to $99,999,999	11.8	12.3	11.6	11.8	11.1	11.1	10.4	9.2	7.3	7.6	9.2
$100,000,000 to $249,999,999	11.5	12.1	9.9	13.0	11.2	11.0	10.0	10.1	7.4	8.5	9.2
$250,000,000 to $999,999,999	13.2	13.6	10.9	13.6	11.8	11.3	10.3	10.3	7.4	8.3	9.6
$1,000,000,000 and over	14.9	14.9	11.1	15.9	16.0	14.0	11.8	13.7	9.5	8.8	9.1

owners and expense allowances may be larger in proportion to total earnings than they would be in the case of larger businesses. Nevertheless, the investor's unfavorable general impression of small business earnings ratios and fluctuations will have a bearing on the price and terms of the successful offering and on the unit selected for financing.

E. Problems of Presentation

Investment sources complain of the inability of the small businessman to make an adequate presentation of his business so that they may determine easily whether it is the type of enterprise in which they will be interested. The costs of examining businesses are quite high. Based on past experience, most institutional investors, venture-capital concerns, and underwriting firms know that only a small percentage of applicants will interest them.[18] Accordingly, the preparation of the descriptive brochure, as well as presentation to the right source of funds, are matters of importance. A survey of the business, adequate financial analysis (including earnings

[18] See FEDERAL RESERVE REPORT 531.

projections), data with respect to the markets and competition, detailed statements of financial needs and relation thereof to earnings, and growth statistics and other support for the asserted growth potential must be carefully developed if the application is to succeed.

F. Problems of Management

The average small businessman is experienced primarily in production, or sales, or both, and usually is not well grounded in internal finance. Many institutional investors and underwriting firms will refuse to finance a company that does not have an experienced treasurer or financial advisor. Good accounting and cost controls, and the ability of the accounting department to develop adequate data for management decisions are deemed important.

Of greater importance, perhaps, than any of the other complaints is that which is voiced against the strength of the management of the small enterprise.[19] As a normal matter, the investor wants only a passive role. He is unable, and it is too costly for him, to devote time to the daily administration of the company in which he has invested. Accordingly, there must be competent management in depth. In many cases, management is a one-man affair, and that one man is spread very thin. He is often a jack-of-all-trades and can attend only to the most urgent problems. The ability of a business to grow can often be measured in terms of its management depth and calibre.

In addition to the matter of depth to handle the daily operations, there is the problem of succession. A company which is dependent on one man may turn from a profitable to a failing operation upon the death or incapacity of that man. Replacements may not be available when the crisis arises. The refusal of management to fortify itself with younger men is often an effective barrier against financing.

Various solutions to these problems may be available. Merger with similar smaller companies, addition of developed products, expansion of personnel, engagement of engineers, market specialists, and other professional experts, and similar methods may assist in developing a successful financial program.

III

SOURCES OF FUNDS: PRIVATE INVESTORS[20]

In some instances, private capital may be the only kind available to the small enterprise. In other cases, where there is a choice, private capital may be preferable to fortify management, to provide banking facilities, or for cost reasons. Usually, however, the smaller initial costs of obtaining private venture capital (savings of pro-

[19] *Cf. id.* at 322.

[20] This section is based primarily on experiences of this writer and, in part, on a recent limited survey of the field contained in the *Federal Reserve Report*. The latter reflects interviews with 11 private investors and 11 venture-capital funds (plus a few brokers and others). Of these, only 7 were based in New York. The survey is admittedly too limited for statistical purposes, and some of the answers given by the persons interviewed (as to control, for example) may be open to serious question. However, the consensus of opinion on some problems, particularly size, appears to be sound.

fessional fees, printing costs, and the like) will be compensated for in the basic cost of the private funds.

The sources of private capital include wealthy individuals, investing syndicates or groups (including investment banking firms for the accounts of their partners or a few selected clients), closed-end investment companies, corporations seeking diversification, and venture-capital firms.

A. New Enterprises

The unusual idea or invention may, at times, attract venture capital (either in equity or loan form) at inception of the enterprise, if the promised reward appears great enough and its realization reasonable of anticipation. Businesses with dramatic electronic and military inventions, or in the fields of shipping, mineral exploitation, manufacture of aircraft rockets and related items, automobile-parking devices, unusual industrial items, and many others have been financed before the success of the device was proved. Each case is a separate problem, and few generalizations, if any, can be drawn from a cross section. The inventor or owner with no funds may find it necessary to part with control in exchange for living expenses and funds for development. Usually, a prototype of the invention must be developed to lure the capital, and the inventor who requires funds to build the prototype is, indeed, in a difficult position (although, on occasion, even that kind of financing can be found).

During the past decade or more, at times when the country's speculative fervor has been great, many new enterprises have been financed by small public offerings, often on a basis substantially more favorable to the owner than would have been accorded to him by knowledgeable private investors.[21] However, the resultant high incidence of failure, not fully appreciated initially by the public investor, has effectively reduced the number of prospective investors in this type of speculation as each cycle has run its course. Only under unusual circumstances will the established financial firm today lend its name to such public offerings of new enterprises.

B. Established Enterprises

Private capital is more readily available for the enterprise with some record of earnings. The earnings potential must be substantial, and many sources require the company to be of sufficient size to merit an investment in excess of $100,000 (some sources require a minimum of $250,000), because of the expense of investigation and other factors.[22] The private investor will often insist upon a position which will

[21] Such offerings are usually made under SEC Reg. A, and offerings of this type, often of securities not suitable for the public investor, have brought Reg. A into some disrepute. There has been some confusion between the problem of the small Reg. A offering and the financial problems of the small business community generally. *Cf.* FEDERAL RESERVE REPORT 539. Some persons have contended (because of speculative excesses) that small business offerings are all of doubtful validity. Others have concluded that the way to solve the financial problems of small business is to "liberalize" Reg. A (in substance, eliminating substantial requirements as to disclosure). Neither conclusion is sound.

[22] A partner in the J. H. Whitney & Co., a leading venture-capital concern, stated in a speech before a session of the American Management Association on December 2, 1958, in New York that in the past 12 years, his concern had considered 7,000 enterprises or projects, but had made investments in only 50 of them.

enable him to move quickly to protect his investment. This may require a shift of control under specified adverse conditions.

On occasion, private financing is supplied by investment firms or partners of investment firms who see prospect of an eventual successful public offering at a higher price and are willing to invest funds for a period until the company can be developed to public offering status. In such cases, the company or the principal stockholder will be able to sell less than a majority interest. At times, however, such deals, which have started with the sale of minority interests, have involved the sale of majority control before the public offering stage was reached. The investor must hold himself ready to provide all financing necessary to bring the company to the public offering stage. The increase in investment is not always voluntary.

As a general matter, private investment in the small business is viewed by the investor as a prelude to a public offering and resulting liquidity. The initial investment, however, is "frozen," since no market then exists. The period of "freeze" to which the venture-capital firm or investing group will submit varies from case to case, but it may run from two to five years. Some of the venture-capital funds establish as a goal a twenty per cent capital gain per year of investment,[23] but that goal is not often reached.

In order to provide the investor with a capital gain opportunity, he must usually receive stock, or stock options, or both. On occasion, he may accept notes or bonds for the face amount of his investment, together with a substantial block of stock, options, or warrants for his potential capital gain. As is true with respect to other sources of capital funds for the small business, debt securities alone usually will not attract funds from private investors.

The small enterprise may sometimes be able to solve its problems by merger with a larger, well-established organization interested in diversification or in supplementary facilities or products. Such larger companies may pay more for an acquisition than any other source. Continuance of existing management can usually be assured by agreement, but control of the enterprise often passes to the acquiring corporation.

IV

SOURCES OF FUNDS: INSTITUTIONAL LENDERS[24]

One of the important financial developments in the past twenty years has been the growth of life insurance companies as the principal buyers of corporate debt

[23] *Cf.* FEDERAL RESERVE REPORT 536.

[24] The data in this section are based primarily on information collected by the writer in a survey of insurance companies conducted in September and October of 1958. The principal source of industrial loans to small business has been the life insurance companies, many of which are looking to the field for the first time. Hence, only life insurance companies were surveyed. Inquiries were directed to 80 companies (constituting substantially all) with admitted assets in excess of $100,000,000 and about 20 with assets less than that amount. Replies were received from 75% of the insurance companies. Inquiries were supplemented by several personal interviews. In addition, reference has been made to LIFE INSURANCE ASSOCIATION OF AMERICA, SURVEY OF LIFE INSURANCE LOANS TO BUSINESS AND INDUSTRY (Joint Investment Bull. No. 321, 1957) [hereinafter referred to as LIAA STUDY], covering 67 companies

securities. Private placements (nonpublic offerings) of corporate debt have risen from $1,004,000,000 in 1945, constituting 20.7 per cent of all corporate debt issues, to $3,389,000,000 in 1956, constituting 38.6 per cent of all corporate debt issues sold in that year. In 1957, insurance company purchases accounted for ninety per cent of total private corporate debt placements, and for the period from 1953-56, the insurance companies acquired about five-sixths of all such private debt placements.[25]

A. Size of Borrower and Loan

Although there are practical minimum size standards, the primary inquiry of the insurance lender relates to growth potential, stability, management, and competitive and market factors. A good risk may be below any rule-of-thumb minimum.

Of the country's eighty insurance companies with assets exceeding $100,000,000, almost half have indicated that they have a policy of making industrial (nonreal estate) loans to businesses that may properly be considered in the small business category.[26] The minimum sizes of loans and borrowers depend, in part, on the location of the borrowing company in relation to the lender; in part, on the facilities which the lender has established to sift applications and examine prospective borrowers; and in part, on the strength of management and other factors peculiar to each borrower. Money market conditions are also important.

Several of the insurance companies indicate that they will make industrial loans as low as $100,000 (and in a few instances, below $100,000). The others interested in loans to small business have indicated that they will lend in amounts of $250,000 and more; a few have minimum loan limits of $500,000.

The minimum size of the borrower is not determinable with any certainty, but borrowers with less than $250,000 to $350,000 of net worth find it very difficult to borrow from insurance companies. Most companies appear to prefer borrowers with total assets in excess of $1,000,000 and posttax annual earnings at or above the $100,000 level.

The foregoing reports of lending policies in 1958 may be compared with the analysis of life insurance company industrial loans in 1953-56 in table two.[27]

A comparison of industrial size statistics with the above loan analysis indicates that only the upper part of the small business community has been receiving industrial loans in a proportion commensurate with its asset position. The business community has been analyzed from the asset viewpoint in table three (based on 1953 tax returns).[28]

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with 77%, of total life insurance assets. Such data were supplemented by reference to 2 DEWING, *op. cit. supra* note 13, at 1107-21; E. R. COREY, DIRECT PLACEMENT OF CORPORATE SECURITIES (1951); FEDERAL RESERVE REPORT 512-24; and 24 SEC ANN. REP. (1958). Note and loan agreements and other forms from the files of the writer and of other law firms and financial institutions were inspected and analyzed.

[25] LIAA STUDY; 24 SEC ANN. REP. (1958); SEC Statistical Bulletins.

[26] Companies below $100,000,000 indicated no interest in industrial nonreal estate loans.

[27] LIAA STUDY tables A-2 and A-4.

[28] FEDERAL RESERVE REPORT 168-69.

TABLE II

INSURANCE COMPANY LOANS

Asset Size of Obligor (Millions)	1953 Amount of Loans	1953 Average Size of Loan	1953 Per cent of Total	1954 Amount of Loans	1954 Average Size of Loan	1954 Per cent of Total
	(Thousands)			(Thousands)		
Under $1	$ 6,517	$ 163	.2	$ 7,365	$ 153	.3
$1 to $2	30,739	530	1.1	21,459	523	.8
$2 to $5	85,717	779	3.1	88,037	616	3.4
$5 to $10	146,447	1,285	5.3	143,171	967	5.4
$10 to $50	440,516	1,907	15.9	661,699	2,290	25.2
$50 to $100	304,874	2,849	11.0	249,446	2,835	9.5
$100 to $500	777,916	2,749	28.0	713,136	3,984	27.2
$500 and over	983,760	6,306	35.4	740,162	6,220	28.2

Asset Size of Obligor (Millions)	1955 Amount of Loans	1955 Average Size of Loan	1955 Per cent of Total	1956 Amount of Loans	1956 Average Size of Loan	1956 Per cent of Total
	(Thousands)			(Thousands)		
Under $1	$ 5,746	$ 185	.2	$ 6,509	$ 224	.2
$1 to $2	22,954	383	.9	23,133	454	.7
$2 to $5	109,623	850	4.1	133,702	955	3.9
$5 to $10	151,271	1,201	5.6	184,965	1,321	5.4
$10 to $50	650,408	1,891	24.3	687,732	1,926	20.3
$50 to $100	324,120	1,884	12.1	569,749	3,063	16.8
$100 to $500	1,098,145	4,673	41.0	1,128,725	3,300	33.3
$500 and over	316,450	2,416	11.8	656,451	3,907	19.4

Slightly more than ten per cent of all industrial loans by life insurance companies during the 1953-56 period were to companies with assets under $10,000,000. Based on the above statistical sample, it may be concluded that companies in that size category held 34.1 per cent of total corporate assets during 1953. A similar comparison of loans and assets with respect to companies with assets between $1,000,000 and $5,000,000 indicates a closer correlation. Companies of that size owned about 9.8 per cent of total corporate assets and received about 4.5 per cent of the non-mortgage loans by life insurance companies during the period. In the area of $5,000,000-$10,000,000 of assets, the correlation between asset position and total loans is remarkably close. Companies of that size accounted for 5.5 per cent of total assets and received 5.4 per cent of total loans.

In addition, the insurance companies loaned over $4,250,000,000 to business and industry on mortgage loans in the period 1953-56. An analysis of all such loans in terms of size of borrower is not available, but an analysis of about one-third of the loans indicated that approximately sixty per cent were made to borrowers with less than $5,000,000 of assets.[29]

The complaint of lack of loan funds comes principally from the multitude of

[29] LIAA STUDY table C-2.

TABLE III

ASSET POSITION

Total Assets	Asset Size (Per cent of total)	Number (Per cent of total)
Under $50,000	5.7	92.2
$50,000 - $100,000	2.8	3.5
$100,000 - $250,000	4.0	2.4
$250,000 - $1,000,000	6.4	1.3
$1,000,000 - $5,000,000	9.8	0.4
$5,000,000 - $10,000,000	5.5	0.1
Above $10,000,000	65.9	0.1

prospective borrowers at the lowest end of the business scale. The insurance companies contend that such borrowers are not able to meet the standards which they must observe. Many applicants with less than $1,000,000 in total assets, and almost all those in the area under $250,000 of total assets, are said to lack the characteristics of a sound borrower not because of size alone (although size in the lower levels is increasingly important), but because of their inability to meet standards with respect to earnings, stability, management, and the like which the lenders are required to observe. Furthermore, loans to companies at the lowest end of the scale usually are not profitable to the lender. The difference between the maximum interest which the insurance company will charge and the interest rate of higher-grade loans is not sufficient either to measure the risk[30] or to compensate for increased costs.

B. Other Limitations and Considerations

No general pattern of area or type restrictions is discernible in the analysis of loan policies. Some companies will lend on a nation-wide basis, except that an isolated loan in an area where the company has no other business must be of sufficient size to justify the expense of examination and supervision. Others restrict themselves to the area adjacent to the lender's home office or to the area where the lender's insurance business is conducted. A few companies exclude loans to certain industries.

Where the applicant is attempting to remedy undercapitalization by overborrowing, a limited public offering may supply the capital necessary to satisfy the insurance companies, and the fact that the insurance company is willing to make a loan to such a company may facilitate the public offering.

Many of the insurance lenders are interested in inflation hedges such as options, warrants, conversion features, and the like. Such considerations, at times, may induce the making of a loan which is not competitive solely on an interest basis. On occasion, preferred stock will be purchased.

Generally speaking, loans exceeding one-third to one-half the amount of the borrower's net worth are frowned upon. Interest coverage (ratio of operating earnings to total interest requirements) of at least four times (some companies indicate

[30] Most recognized leaders, particularly in the institutional field, will not permit a rate substantially in excess of 6%. *Cf.* FEDERAL RESERVE REPORT 15.

much higher) may be insisted upon. Most companies require a ratio of at least 1.5 in the relation of past average operating earnings to postfinancing annual interest and sinking fund charges. Other ratios (total debt to cash earnings available for interest, term debt to fixed assets, current assets to current liabilities) may also be considered important.

The borrowers must expect to have restrictions imposed with respect to executive salaries and expense accounts. If the loan is an unsecured loan, it may be expected that mortgages and liens will be prohibited, with specified exceptions, in order that the company may not mortgage its property to the detriment of the unsecured lender. Dividends may be prohibited; and minimum working capital and maximum permissible borrowings may be specified. Restrictions on working capital, borrowings, liens, asset acquisitions, and other similar matters must be carefully screened, so as not to hamper the company's growth. Restrictive clauses, as well as interest rate and principal amount, lend themselves to some "horse-trading."

Development of the loan presentation requires time and effort, as well as expense. Financial data for ten to twenty years will be required. The purposes of the loan must be carefully worked out in collaboration with the borrower's accountants. Market surveys and engineering studies may be useful. In comparing the cost of the insurance loan with the cost of the public offering, the expense of this examination must be taken into account. Private placement costs may also include finder's or loan broker's fees, as well as legal, accounting, and printing costs.

The private placement has certain advantages over the public offering. Negotiations are direct with the lender, so that the deal can be tailor-made. Furthermore, at a time when public markets may be volatile, the commitment of an institution will be more secure than the prospect of proceeds of a public offering. Also, some companies which do not meet the public requirements of growth potential may find a more sympathetic response in the institutional lender. And in the event of a default or need for variation in terms, modifications of the contract may be simpler than in the case of publicly-held debt.[31] The out-of-pocket costs of a private placement are usually somewhat less than those of a public offering. Registration costs are saved, and legal, accounting, and printing costs are reduced.

Summarizing, institutional loans can be a source of long-term loans to a part of the small business community. Insurance companies vary greatly, but a number of them will consider loans as small as $250,000, and several will consider loans in the area of $100,000 or below. Usually, acceptable borrowers will have net worths not less than $250,000 to $350,000. Management, type of business, nature of product, and other similar factors will have an important bearing on the treatment of the loan application. Costs will be less than those encountered in the case of public offering. Some insurance companies are interested in inflation hedges, but none will accept such features as justification for a loan to an undercapitalized borrower.

[31] *Cf.* 2 DEWING, *op. cit. supra* note 13, at 1112.

V

SOURCES OF FUNDS: THE PUBLIC OFFERING[32]

Public securities offerings of small businesses are usually in some form of stock or in bonds convertible into stock (or with stock warrants attached). Combinations of stock and debentures or mortgage bonds may also be salable, but in general, the small business has only limited access to the public corporate debt market, as such. Investors view the small business company primarily as a source of equity investment for capital gain.

A. Advantages of Public Offering

The primary reason for a public securities offering is to raise funds for the operations or expansion of the issuer. ("Secondary offerings" by stockholders in the first instance, before a public market has been established, are not viewed with favor by many underwriters, although the exceptional case recurs. At times, a combination primary and secondary offering may be made.) In addition to obtaining capital, there are other advantages to be realized by a public offering. The establishment of a market is of advantage to the company's credit, as well as to its stockholders who may desire to improve the liquidity of their holdings.[33] At times, securities can be sold to the public on terms and at prices more favorable than those available in a private offering.

Furthermore, a company with public stockholders may be controlled by management with substantially less than a majority position. In addition, once a public market is established, the company will be able (except at times of stress or unfavorable operating results) to raise funds more easily than before.

B. Size and Nature of the Issuer

Attractive growth companies, with recent average annual net earnings not less than $100,000 to $150,000 and net worths above the $400,000-$500,000 level, are the issuers of most of the better small offerings, but in some instances (particularly in the Regulation A offering described below), net worths and earnings are smaller than those amounts. Earnings, in fact, vary widely; at times, an absence of earnings, or a loss, does not prevent an offering. Size of total assets is not a discernible standard.

Fads in industries, as well as in types of securities, are apparent. Economic or financial developments, from time to time, increase the popularity of one industry or another; and such developments are often reflected in the public offering statistics.

[32] The discussion in this section is based in part on an analysis of about 350 prospectuses for issues (other than those of utilities) under $3,500,000 sold during the period 1956-58, constituting substantially all the issues of that size advertised during that period in the Wall Street Journal and Investment Dealers Digest. Reference has also been made to 1 DEWING, *op. cit. supra* note 13, at 290-308; 2 *id.* at 1019-140; GEORGE J. LENESS, ET AL., NEW MONEY FOR BUSINESS (1956); FOULKE, *op. cit. supra* note 8. The discussion relates to nonutility companies.

[33] Recent amendments to the tax statutes permit payment of inheritance taxes over a 10-year period, which may reduce the pressure by stockholders for marketability. INT. REV. CODE OF 1954, § 6166.

But analysis of successful offerings indicates that few, if any, legitimate industries or types of companies are to be deemed excluded from the market if the issuers possess the right combination of attractive features signalling growth potential.

C. Approaching the Underwriters

To the inexperienced, the financial community may appear to be a monolithic structure, operating more or less efficiently to transmit public investment to the users of capital. Under the microscope, however, it resembles an anthill, alive with thousands of ants, different in size, color, and function. "Wall Street," as a description of the nation's financial center, consists of intermediaries and lenders, banks and brokerage houses, and numerous other specialists in the financial business, functioning from coast to coast. There are almost 4,000 firms of securities brokers and dealers, most of which specialize in various functions or types of securities or issuers. The New York Stock Exchange has 1,348 regular members, of which perhaps half or less represent the "wire houses," or major securities brokers as the public knows them. These same firms constitute the bulk of the 499 regular members of the American Stock Exchange. Several well-known underwriting firms are not members of any exchanges.

For our purposes, securities dealers or brokerage houses may be divided among (1) the trading houses, (2) the firms primarily interested in wholesale or retail distribution of "seasoned" issues or issues originated by others (including firms that specialize in mutual funds or investment company securities) and (3) firms which originate issues (and which may also function as trading or distribution houses). Many houses are interested only in bond distributions; others will not sell the securities of a company below a certain minimum size which may, in fact, be quite substantial from the viewpoint of the small businessman; and still others specialize in securities of one or more specified industries (*e.g.*, chemicals, rails, etc.). Many securities firms of excellent repute and substantial size are interested in small business growth situations.

The underwriter who originates and distributes new issues is a securities merchant. It is his function to package the security in an attractive package and find the right buyers. The successful underwriting firm performs a function similar to that of the lending institution—it culls out the inappropriate and prepares the appropriate issues for public sale. It assists in transforming public savings into business capital.

A proposed offering must compare favorably with similar issues previously marketed if it is to be received sympathetically. The underwriter will examine the proposal to determine whether the offering is of the kind and size that his customers (and those of his associates) will purchase, and whether the time is ripe for marketing the issue. The presentation must include data to indicate the adequacy of the financing sought. Underfinancing must be avoided, since it may leave the company

without funds to realize its goal at a time when other funds may not be available. Overfinancing may render the issuer unable to earn a fair return on its total capital.

Once the underwriter has determined to originate, or buy the issue, "horse trading" results, leading to an understanding on the kind, price, and amount of securities, the underwriting discount, and many other matters. The underwriter will insist on collaborating with the company and its advisors in designing the right capital structure for the company's needs.

D. Valuation of the Enterprise; Price-Earnings Ratios

In order to determine the price of the stock (or the conversion price of bonds), as well as the division between the public and the "inside" stockholders, the issuer must be evaluated. In no aspect of the transaction will there be wider disagreement than in the valuation of the enterprise. A practical solution of the problem may be accepted by the company's management as part of a broader agreement; but often the difference in point of view persists permanently. A part of the difficulty stems from the differences in experience, standpoint, and approach. The businessman who has spent a number of years in the development of the enterprise has a feeling for his business that few can share. The underwriter and the institutional loan officer, who evaluate businesses as a part of the everyday transaction of their affairs, operate largely by financial rules, concepts, standards, and judgments, not always capable of articulation, which the businessman usually does not understand.

Fundamentally, the value of a share of stock lies in the participation which it affords in the *future* earnings of the company.[34] The investor in the going concern does not intend to purchase a part of an enterprise to be liquidated,[35] or of real estate or other physical assets. Hence, book values, good will, plant condition, and similar factors which the owner of the enterprise may consider of great importance are not principal criteria for determining the value of the going enterprise; they are of significance only, or primarily, in their relationship to future profits.[36]

Different views may be taken of earnings and values for different purposes. The sale of an entire business may be based on one set of standards; the sale of a minority bloc of stock may be based on another; and the sale of a controlling interest on a third. The persons who buy a going concern, "lock, stock, and barrel," will value it, in part, in terms of their own conditions and the special emoluments they anticipate. Cost savings, overhead reduction, loss tax-credits, salaries, and other items may have an important effect on estimated earnings, and hence on the price they are willing to pay. A company engaged in expansion for diversification or production integration may, at times, put a higher valuation on the enterprise than the public. On the other hand, a knowledgeable buyer may be unwilling to accept the public appraisal.

The past record is important primarily as an indication of trends and future

[34] *Cf.* 1 DEWING, *op. cit. supra* note 13, at 287.

[35] Although, on occasion, this type of investment is sold.

[36] BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS 429, 491 (1934).

earnings. By itself, however, it is not the basis for sound conclusions as to earnings potentials. These can be guessed at only after an examination of all important aspects of the business, including other financial data.

In connection with the determination of past earnings, the calibre of the company's accounting department and the policy underlying the keeping of its records are important. To the small businessman on his way up, accounting records may not be a major concern, except as a basis for tax reports and collection of accounts. Overliberal attitudes toward expenses and overconservative attitudes toward assets and income lead to problems in appraisal of earnings and differences of opinions as to the true earnings potential of the company. Auditors will be bound by facts then available, and the underwriters will relate their thinking to earnings as certified by reputable auditors. They will usually not make allowance for asserted earnings, unless reflected in data usable in the offering prospectus.

Undoubtedly the most important single factor in the determination of potential earnings and in the estimate of value of the usual small business—manufacturing, finance, service, etc.—is the calibre of management. Small companies are relatively speculative. They are valuable because of growth potential, which, in turn, is dependent, in good part, on the ability of management. Management may be more important in that type situation than in the case of an enterprise, such as a water company, where earnings are dependent to a larger extent on fixed assets and monopoly position. Other factors affecting the determination of future earnings would be, principally, stability of the market for the company's product (well-advertised brands vs. unbranded merchandise), patent structure, area limitations and dependence on local economic conditions, position of the enterprise vis-à-vis competition (including consideration of product development research policies), labor conditions, and general economic potential.

When the potential average earnings in the proximate future have been determined, the value of those earnings is estimated by applying a ratio or factor. For example, a company with earnings (after taxes) of $100,000 may have a value of $600,000. The ratio of earnings to value is 6:1 in such case. To this valuation of earnings, modifications or adjustments may be applied for special circumstances. Nonearning assets, or excess working capital must be evaluated. Under or overcapitalization must be considered in relation to prospective returns. The final result is the value of the enterprise for purpose of public offering or private investment. Price per share is an arithmetical derivative of the valuation.

The price-earnings ratio may vary from time to time and industry to industry. It is a reflection of the estimate of the evaluator of a fair investment return at that time and the risk involved in obtaining such a return from that enterprise. The ratio may reflect general thinking in the financial community as well as comparison with the price-earnings ratios of similar companies. A "seasoned" stock, even with characteristics similar to those of the new company, may command a higher price

in the market, and appropriate adjustments must be made for the difference in situation.

While the appraisal is, in good part, a personal determination of the proposed underwriter, it is made with a view to public acceptance of the security to be sold. Such acceptance will be influenced by the estimates of analysts and advisors in the firms, institutions, and others who may be called upon to participate in the distribution. They are familiar with the basic concepts and standards which guide the underwriter; and each will make his own appraisal of the investment value of the security.

Almost by definition, price-earnings ratios do not lend themselves to generalization. Higher ratios (higher prices) are sometimes found for smaller companies than for those larger in asset size. The ratios will vary from issuer to issuer, even at the same point of time. A comparison of five issues sold within a few weeks of each other by well-regarded, top-flight underwriters in the fall of 1958 illustrates the variations. The issuing companies had net worths of $360,000, $1,250,000, $1,400,000, $2,000,000, and $3,000,000, respectively; and indicated current annual earnings (after income taxes) in the area of $100,000, $300,000, $800,000, $400,000, and $600,000, respectively. The companies were engaged in the manufacture of electronic items, chemicals, medical equipment, and building items. Price-earnings ratios (in relation principally to current earnings) ranged from 5:1 to 18 or 20:1. The smallest company (electronics), with the most limited earnings record, obtained the highest price for its stock; the largest (medical equipment) obtained an intermediate price; and an intermediate-sized company, the lowest price. If three years' average earnings were used as a base, the spread was from 5:1 to almost 50:1. A similar analysis of a group of companies in January 1959 revealed the same striking differences. The ratio of current or recent earnings to offering prices is not, of course, a reflection of the full valuation formula. In each case, there were presumably various reasons for the ratio and resulting price—reasons which others might weigh differently. However, rules-of-thumb by authoritative writers, using ratios of four to 8⅓ times (twelve to twenty-five per cent or higher returns),[37] depending on degree of risk, are subject to question. Ratios of eight to twelve times used by the Securities and Exchange Commission in its evaluation of enterprises (other than electric and gas utilities) for reorganization purposes[38] reflect the conservative approach of the financial expert for reorganization purposes, and not necessarily the attitude of the businessman who runs as he reads and who is dealing with growth and optimism.

E. Interest Coverage and Size of Issue

Variations in interest coverage of bond issues are also substantial. Interest coverage of a finance company issue may be as low as 1.2 times; for a manufacturing

[37] 1 DEWING, *op. cit. supra* note 13, at 388 *et seq.*

[38] See *In re* Northeastern Steel (1957), Corp. Reorg. Release 107 (8 times); *In re* Muntz TV, Inc. (1955), Corp. Reorg. Release 95 (8⅓ times); *In re* Chicago and West Towns Ry., Inc. (1953), Corp. Reorg. Release 92 (12½ times).

company, it may be ten times. As to size of issue (stock or bonds), most underwriting houses object to offerings in an amount in excess of the then capital structure, but there are numerous exceptions.

F. Costs

There are three elements of cost to the seller of the issue: (1) compensation to investors, (2) compensation to underwriters, and (3) other expenses (professional fees, printing costs, and the like). In the case of term financing, the largest cost is the interest paid to investors. Compared to that cost, initial distribution charges are not of major significance, when spread over the life of the issue. For example, a relatively high initial cost of fifteen per cent for distribution of a fifteen-year bond issue adds only one per cent to the average interest cost. A saving in the indicated coupon rate, as compared with other similar issues, may, in fact, make the issue a low-cost rather than a high-cost offering.[39] Total costs will depend more on the timing of the issue and money rates than on out-of-pocket expenses, and may vary drastically, from time to time, in relation to economic swings.

The true cost to the issuer of stock issues (and certain securities convertible into stock) is the difference between the "fair market value" of the stock sold and the net proceeds per share received by the issuer (or the selling stockholder). "Fair market value" may be best defined for this purpose as the price at which a willing, well-informed buyer and an equally willing and well-informed seller will consummate a sale.

Where the issuer receives a higher net price (after all costs) than accepted value standards would entitle him to, it may be contended that the cost of the distribution is borne by the investor, not the seller. Conversely, of course, an underpriced stock may be excessively costly to the seller, even though underwriting charges and other costs per dollar of proceeds are at the lowest end of the scale. Hence, analyses and comparisons of securities costs are not precise. The speculative tenor of the market, passing market fads, and changing economic and financial factors will have a significant bearing on the current dollar cost to the seller.

Public distribution costs of registered issues have been surveyed by the Securities and Exchange Commission. The data in table four, for selected years in the period from 1951 to 1955, indicate that by percentages of total proceeds, distribution costs are greater for the smaller issuer than for the larger, for stock issues than for bond offerings, and for manufacturing and mining companies than for utilities.[40]

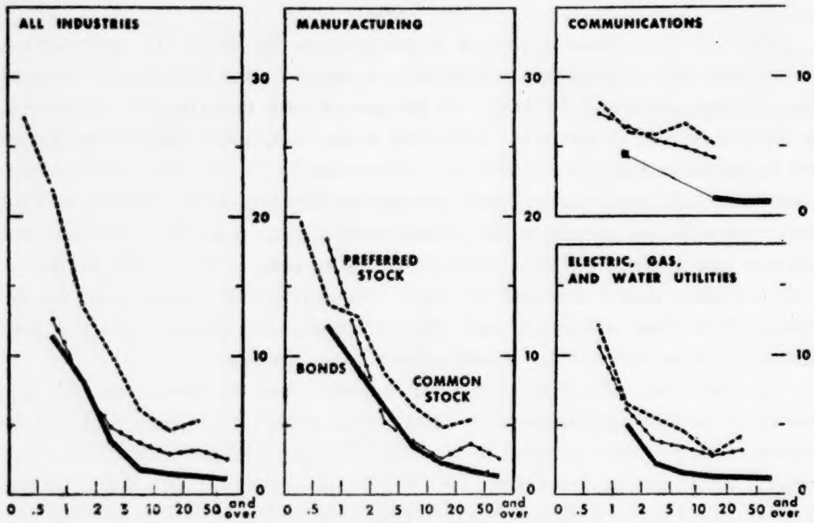
[39] *E.g.*, in September 1958, Sears Roebuck and Company sold $350,000,000 of 25-year debentures at an underwriting cost of ⅞%. Within a few weeks, the issue was selling at a 5% premium. It is arguable that the issue was underpriced and that the cost was extraordinarily high as compared with other issues at the same general time.

[40] See FEDERAL RESERVE REPORT 298. A resurvey in 1957 appeared to indicate somewhat lower percentage costs at the lower end of the size scale, but the sampling was small and conditions were dissimilar, so that the comparison is of doubtful validity. The decrease in the high-cost uranium issues and high market levels may have been contributing factors.

TABLE IV

Comparison Within Industry—Issuer Groups of Cost of Flotation of Registered Securities

by type and size of issue



Note: Average cost of registered securities offered to the general public through investment bankers in 1951, 1953, and 1955.

Sources: SEC, Cost of Flotation of Corporate Securities, 1951-1955 (1957); Federal Reserve System, 85th Cong., 2d Sess., Financing Small Business 290 (Comm. Print 1958).

A similar survey by the Securities and Exchange Commission of average underwriting cost during the 1951-55 period revealed the data in table five.

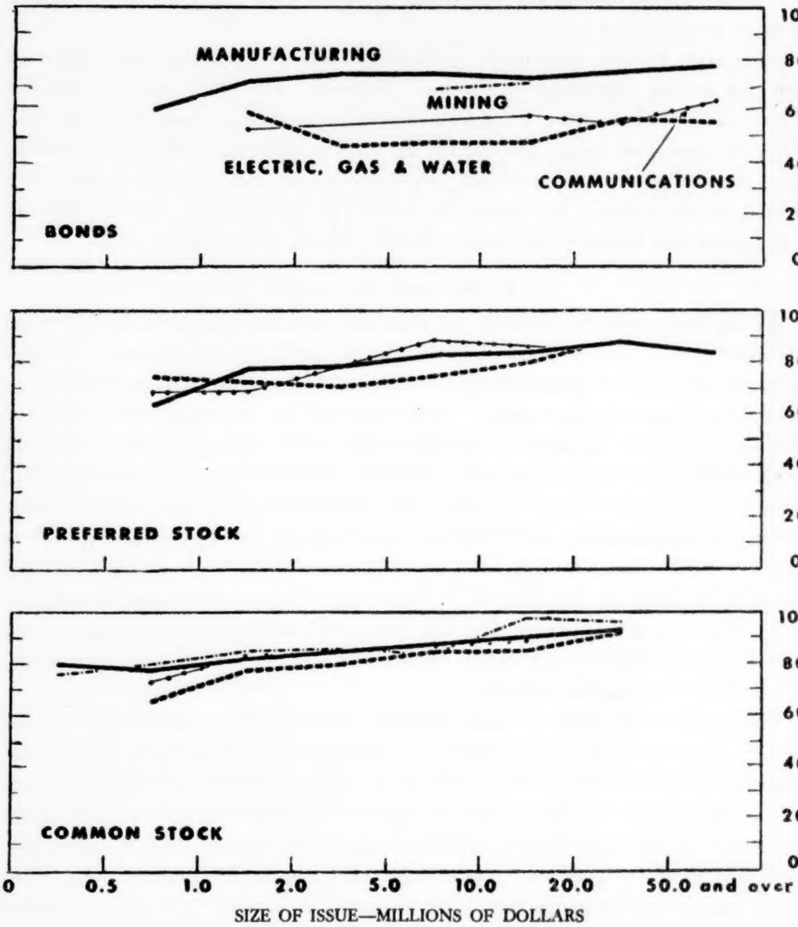
An examination of prospectuses in 1958 for issuers with net worths in the \$1,000,000-\$3,000,000 class disclosed underwriting commissions, in general, of from seven to fifteen per cent for stock issues, and from five to ten per cent for debt issues (usually convertible debentures or unit offerings). A similar examination of prospectuses for 1956 and 1957 indicated the same spreads, but there were numerous exceptions in each year. A survey of issues in the \$300,000 class (Regulation A issues, discussed below—not including small issues by large companies or those with established markets) indicated underwriting commissions ranging from ten to twenty per cent, with most issues in the fifteen-to-twenty per cent class.[41] In all periods referred to, compensation to the underwriters in the form of stock or options have not been considered because of statistical difficulties. Such compensation is, at times, of importance.

[41] A survey by the Securities and Exchange Commission of Reg. A costs in the 1951-55 period appeared to indicate that total percentage costs were less than those of some registered issues, but the sampling is small and the statistics are open to question. *Cf.* Federal Reserve Report 299.

TABLE V

COMPENSATION TO UNDERWRITERS FOR SELLING REGISTERED SECURITIES BY INDUSTRY—ISSUER GROUP AND SIZE OF ISSUE

Compensation as percentage of total flotation costs



SOURCES: SEC, COST OF FLOTATION OF CORPORATE SECURITIES, 1951-1955 (1957); FEDERAL RESERVE SYSTEM, 85TH CONG., 2D SESS., FINANCING SMALL BUSINESS 294 (Comm. Print 1958).

Variations in rates are accounted for, in part, by timing and the type of issue and issuer. Difficulty of distribution is also a factor in costs. Underwriters contend that new issues of small companies are more difficult to sell than accepted issues in varying degrees, and that to induce dealers and salesmen to engage in the distribution of the unseasoned issue rather than the more easily sold mutual funds and other seasoned issues, it is necessary to compensate them on a competitive basis.

Variations in underwriting rates may be dependent on other factors, as well. A market glut of new issues will force underwriting rates up. On the other hand, at a time when the market is involved in a speculative surge and competition for good issues is keen, good trading and knowledge of available sources can often result in a saving of underwriting costs.

Other costs include, principally, professional fees and printing costs, and vary from case to case, depending on the work required. The work involved does not relate to the size of the issue. Such costs may be six or seven per cent for the $500,000 to $600,000 issue, four or five per cent for the million-dollar issue, and proportionately less as the size of the issue increases. Professional fees in substantial amount often result from the necessity for setting the issuer's house in order, a service required in any event and related to the public offering only in point of time.

G. Underwriting Agreement

Having negotiated the terms of the financing and the price of the security (the definitive offering price is usually agreed upon at the last moment before offering), the parties and counsel, principally the latter, develop the terms of the relatively complicated "underwriting agreement." Preparation of the necessary audit, legal and offering documents, registration statement, and other reports, together with the period required for registration under Securities Act and state "blue sky" laws, will consume two or three months or more. During that period of time, although there will be an understanding on the details of the transaction, no agreement will be signed, or in any event, no legal liability will be assumed by the underwriter. Only when the securities are available for delivery will the underwriter agree to purchase them. The closing or payment date will usually follow the public offering by a few days; the public offering will usually be made as soon as possible after the effective date of the registration statement.

The practice and policy of underwriting houses not to commit themselves until immediately prior to the public offering is uniform and well-established among substantially all underwriting firms. The underwriters contend that financial markets are so volatile that no underwriter can agree to stand by for the duration of the preparation period. An issue is negotiated against the background of specific economic and financial conditions. Price and terms are set in that context. The underwriter has no way to hedge such a commitment, as is done in many other fields. Finally, all brokers and dealers must maintain a prescribed ratio of net worth to total obligations. Accordingly, they refuse or are unable to immobilize substantial amounts of capital for long periods.

In any event, the prospective issuer will find that he must undertake the preparation of the issue without a binding contract for the sale of the issue until just before the public offering date. However, the issuer's prospective "exposure" to expense before offering is usually not an item of major size; it is determinable and can be circumscribed within reasonable limits. The issuer may often rely on the moral

obligation and economic incentive of the underwriter to complete the issue, if possible. The reputable house will make the offering under any but the most adverse circumstances, even to the point of losing its profit or sustaining a minor loss, in order to prevent a fiasco. An unsuccessful transaction is a blot on the reputation of the underwriting firm; and it will also be out of pocket if the issue fails.

Underwriting contracts vary in tenor from the commitment which becomes firm on signature of the contract, subject only to a holocaust, such as war, etc., to the contract at the other end of the scale, the "best efforts" agreement, which does little more than obligate the underwriter to use his "best efforts" to sell such part of the issue as he can. In the case of the weakest "commitment," the underwriter must, in any event, purchase all, or a specified portion, of the issue, if he is to purchase any; in the "best efforts" agreement, the underwriter may "take down" whatever he sells, and there is no penalty for failure to sell all or any substantial part of the issue. A "best efforts" agreement may be justified where the record of performance of the underwriting house is good, but its capital is limited, and where, as in the case of a finance company, any significant portion of the offering can be put to use profitably. It should not be used where a minimum amount of proceeds is essential for the issuer's program.

Although the issuer will deal with only one underwriter, often the underwriter will not distribute the issue by himself. In the "commitment" transaction, he will usually form a syndicate or a group of underwriters. The underwriting agreement will be so drafted that each member of the syndicate agrees directly to acquire a specified portion of the issue.

In addition to the commitment or "best efforts" clauses, the underwriting agreement is a complex structure containing many other provisions. It prescribes the kind of security to be sold, the selling period or consummation date, and the underwriting discount to be paid. It includes representations by the company as to its corporate structure, condition and financial data, an undertaking to prepare and file a registration statement which shall be accurate, agreements by the company to indemnify the underwriter (and by the underwriter, to indemnify the company) against misrepresentations in the prospectus, agreements for payment of expenses (the issuer usually pays the fees of the counsel for the underwriter), covenants with respect to qualification under "blue sky" laws, and many other items. Salary and dividend limitations may be required to make the issue marketable. As a usual matter, the underwriter will reserve the right of preference or first refusal in connection with future sales of securities, public and/or private, and the agreement will provide that the underwriter shall be entitled to representation on the board of directors and to receive current financial and other data with respect to the company. On occasion, the underwriting agreement provides that the underwriter shall receive options or warrants (but this may not be permissible in certain states). During the period of the public offering, and usually for a number of months thereafter, the company and its principal stockholders may be required to agree not to sell any

stock or other securities to the public (and at times, privately) without the consent of the underwriter.

VI

PREPARING THE ISSUE FOR MARKET

Once there is general agreement on the terms of proposed offering, the company and its professional advisors must turn their attention to the requirements of the Securities Act of 1933 and applicable state securities regulation statutes ("blue sky" laws). The Securities Act of 1933 requires, in substance, that any issue sold in interstate commerce must be registered unless the transactions or the securities are exempt.[42]

A. Private Offerings

Transactions involving institutional or other private investors can usually be brought within the exemption provided by section 4(1) of the Securities Act of 1933 for private transactions.[43] Whether or not a particular transaction is exempt must be carefully examined by counsel. The exemption may depend not on the number of persons involved, but on the nature of the transaction.[44]

B. Local Offerings

Restricted local public offerings may also be made, without registration, to persons resident within a single state or territory, where the corporation is incorporated by and doing business within such state or territory.[45]

In such case, it is important that the investors be residents of the state of incorporation and that their purchases be for their own accounts and not for nonresidents. A sale of part of the issue to a single person not a resident of the state will void the exemption. Most issuers have found it necessary to obtain written assurances of residence and investment intention. An offering may not be begun locally and then expanded. If a local offering and an interstate offering are so connected, or "integrated," as to constitute, in fact, one offering, the exemption will not be available. Once the issue has been sold, however, in a manner consistent with the exemption, a subsequent bona fide transaction by the investor will not void the exemption.

The advantage of the exemption relates primarily to costs; no registration statement is required to be prepared. However, few offerings can be accomplished without any prospectus, and when the prospectus is prepared, it must be as carefully devised as any other document used to solicit public subscription. Misrepresentations in such documents fall within the prohibitions of the Securities Act of 1933, notwithstanding the exemptions.[46] A result of such exempt offerings will be a high con-

[42] 48 STAT. 74, 15 U.S.C. §77a *et seq.* (1952).
[43] 48 STAT. 77, 15 U.S.C. §77d(1) (1952). See LOUIS LOSS, SECURITIES REGULATION 394 (1951).
[44] See *In re* Gilligan, Will & Co., Securities and Exchange Act Release No. 5689, May 7, 1958.
[45] Securities Act of 1933, § 3(a)(11), 48 STAT. 75-76, as amended, 15 U.S.C. §77c(a)(11) (1952).
[46] *Cf.* Securities Act of 1933, §§ 12(2), 17, 48 STAT. 84-85, 15 U.S.C. § 77 l, q (1952).

centration of stockholders immediately adjacent to the company's principal operating area.

C. Regulation A

A more important exemption is to be found in section 3(b) of the statute.[47] That section permits the Securities and Exchange Commission, by regulation, to exempt issues not exceeding $300,000 in total offering price. The section was enacted to permit exemption of offerings so limited in character or amount that registration was not considered necessary in the public interest and for the protection of investors.[48] The exemption was intended to be used sparingly and to provide more flexibility in the area of issues which were almost, but not quite, intrastate or nonpublic.[49] The exemption originally covered $100,000, but was increased in 1945 to $300,000.

Prior to 1953, practically no data were required to be used. However, if offering circulars were used they were required to contain a few items of information and to be filed with the Securities and Exchange Commission. In 1953, the regulation was changed to require certain disclosures as a condition of the exemption. In 1956, the regulation was further amended to impose additional requirements on those using the regulation.

At present, Regulation A is available for offerings not exceeding $300,000 by issuers, and not exceeding $100,000 by controlling persons. Amounts up to $50,000 may be sold (except in certain cases) without the use of an offering circular, but data similar to that required in an offering circular (except for financial data) must be filed with the Securities and Exchange Commission. Offerings above $50,000 require the use of an offering circular, including some financial data which need not be certified.[50]

Although such Regulation A offerings are often called "short form registrations," they are not registrations. The examination procedures and required data are substantially different. The Regulation A documents are examined by regional offices of the Securities and Exchange Commission rather than by the Washington office. The regulations require a ten-day filing period instead of the twenty-day minimum registration period, but substantially longer than that is often required. Actually, there is no clearance or similar procedure. The procedure is rather informal, and quite time-consuming. Requirements may change from regional office to office, although the Commission has attempted to coordinate examination procedures by establishing a special group in Washington to review practices.

The original purpose of Regulation A to provide a method for offering small issues more cheaply, more quickly, and more favorably than in the case of registered issues has not been realized in many cases. The only difference in out-of-pocket

[47] 48 STAT. 76-77, as amended, 15 U.S.C. § 77c(b) (1952).

[48] House Committee on Interstate and Foreign Commerce, *Federal Supervision of Traffic in Investment Securities in Interstate Commerce,* H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933).

[49] The Commission was to observe "the prima facie requirement that every security and transaction not specifically exempted by the terms of the bill should be kept within its scope." *Id.* at 6-7.

[50] 1 CCH FED. BANKING L. REP. 2181 *et seq.*

costs between Regulation A and registered issues may be a small reduction in printing charges and perhaps in legal fees. The total cost of a Regulation A offering, considering the underwriting charges often applied to such cases, is probably little less than the cost of a registration statement economically handled.

As against this saving, issuers may find their choice of underwriters restricted. Although the Regulation is merely the avenue, and not the vehicle, many underwriting firms feel that the use of Regulation A creates the impression of failure to meet conservative standards. Such an impression may often be unjustified, but the extraordinary use heretofore of the Regulation for highly speculative and unsound offerings has created that impression. The type of underwriting arrangements ("best efforts") usually encountered in such cases and the fact that many issues were only partly sold or not sold at all are also contributing factors in the current attitude toward Regulation A.

The imposition of higher disclosure standards and the current attitude mentioned above reduced the former widespread attraction of the Regulation for many issuers. From a total of $176,000,000 of prospective offerings filed under Regulation A in 1956 (involving approximately 1,500 separate offerings), filings under the Regulation fell to $114,433,000 in 1957; and during the first six months of 1958, they were about twenty per cent below the same period in 1957.[51] Nevertheless, on occasion, Regulation A may still be conveniently and satisfactorily used for local or quasi-public issues not exceeding $300,000 in aggregate ultimate offering price.[52]

The preparation of an offering circular and notification statement under Regulation A requires considerable care. Counsel will usually advise the client to include a fully certified balance sheet and three years' profit and loss statement, together with many of the items required in registration statements, even though the Regulation permits less.

After an examination period, which may last from two to four weeks, the company and its underwriter are then in a position to make a public offering. At the end of each six months, there must be a report made as to the amount of securities sold.

D. Registration Statement

Registration under the Securities Act is accomplished by a registration statement, which is filed with the Securities and Exchange Commission. The Commission has developed an effective registration procedure based on a quarter century of experience. At the present time, issuers past the development stage (with the exception of major companies issuing only debt) must use Registration Form S-1. The registration statement consists of three principal parts: (1) the prospectus, (2) part two, giving certain supplemental data, and (3) voluminous exhibits. The prospectus requires the inclusion of data concerning the underwriting and costs, use of the proceeds, capital

[51] SEC, Statistical Bulletins, April and May, 1958.

[52] Note, *Federal Control Over Small Issues of Securities*, 70 HARV. L. REV. 1438 (1957); 13 BUS. LAW. 303 (1958).

structure, and balance sheet as of a date within ninety days (if not certified, then an additional balance sheet as of the close of the prior fiscal year), together with profit and loss data for a five-year period, if the company has that much record. Many underwriters will request disclosure of a longer record of earnings, if available. Financial data must be certified in accordance with regulations of the Commission by an independent public accountant.[53]

The financial data are subject to rather extensive regulations, which require the filing of supporting schedules. Other exhibits required to be filed include the charter, bylaws, important contracts, underwriting agreement, patents, reorganization plans, voting trust agreement, pension or retirement agreements, and other items of significance. Although the Commission's rules do not require the printing of the documents for filing, it has been the practice uniformly to print the entire registration statement. In the case of the smaller issues, costs can be reduced by using processes other than printing for those parts of the registration statement which are not required to be distributed to the public in quantity. The prospectus, however, which must be distributed to the public, will usually be required by the underwriter to be printed.

Usually, appraisals and forecasts of earnings may not be the basis of representations in the prospectus. On occasion, however, an underwriter may require an independent market survey or an examination of the company by an independent engineering firm and may ask for independent professional earnings' projections to corroborate his own estimate of a company's growth potential. Factual data thus obtained are useful as background data in drafting the registration statement.

The issuer's principal executives may find it necessary to devote considerable time to a survey of their business, its growth potential, its financial needs, and many other items. Such a survey, however, may be necessary whatever the source of the external capital.

Upon filing of the registration statement, the Securities and Exchange Commission will advise the issuer as to additional data the staff may consider essential. The "Letter of Comments" setting forth the data required or the corrections deemed necessary may be forthcoming in two weeks, more or less, after filing. An additional two weeks or more will usually be required to conclude the registration process.

During this registration period, the underwriter is permitted to organize his "syndicate" and selling group of other participating underwriters and dealers, and to distribute a preliminary prospectus (referred to as the "red herring"). However, no orders may be confirmed until the effective date of the registration statement, and then only with a prospectus or after a final prospectus has been distributed.

Since the adoption of the Securities Act in 1933, complaint has often been heard that the Securities Act seriously impedes the financing of small business. Some impediment must, of course, be recognized. A registration statement must be prepared

[53] The SEC will usually not consider an auditor to be independent if he had any direct financial interest or any material indirect financial interest in the issuer or affiliates, or if he was an officer, director, ., during the period under review. *Cf.* Rule 2.01, Reg. S-X.

and filed, and during the period of its examination the issue may not be sold. It is the latter aspect of the case which poses difficulty, since during this examination period, market conditions may change. However, that risk is as much a risk of the large company as it is of the small company. It has long since been accepted that this much risk and inconvenience are justified by the greater benefit to the investor. It is doubtful that any less data would now be required by most underwriters, even if there were no Securities Act of 1933.

E. "Blue Sky" Laws[54]

In addition to the Securities Act of 1933, the company must observe the requirements of state securities statutes. Generally, in the area from Maine to Virginia, the requirements of the state laws are not onerous. More work is required in the case of Vermont, where a type of statute similar to that to be found in the Southeast and Midwest exists.

In the latter sections of the country, regulatory statutes sometimes pose more difficulty. The company with three to five years of earnings, meeting specified return formulae, will usually be permitted to "register by notification," which, in substance, permits satisfaction of requirements by the filing of a copy of the federal registration statement and certain supplementary data. In a few states, securities may be qualified by "coordination" or "description," which requires, in substance, only the filing of the federal prospectus and a few other documents, without regard to earnings and similar standards. Where the issuer is unable to meet the requirements for registration by coordination or notification, more extensive filings will be required. Underwriting costs of stock issues are limited in some states to fifteen per cent. Several states provide that no warrants may be given to the underwriter or officers unless similar warrants are sold to the public. In a few instances, appraisals or similar supplementary data may be necessary.

VII

POSTFINANCING PROBLEMS

When the issue is sold, the underwriter or the institution and the company will meet at a "closing," at which the numerous documents covering the necessary representations, warranties, covenants, etc. will be exchanged. The underwriter or insurance company will pay for the securities and receive delivery of them. After mutual congratulations have been extended and the parties return to their everyday business, problems arise. The company's officers find it necessary to adjust their thinking to the company's status as a public company. The initial period of living in a "fish bowl" may be annoying to the average entrepreneur.

In the case of the private loan, monthly, or at least quarterly, financial reports, extensive in scope, may be required. In the case of the public offering, semiannual, annual, and interim reports will be required for filing with the Securities and Exchange Commission and for transmission to the underwriter. Informative reports

[54] See generally LOUIS LOSS & EDWARD COWETT, BLUE SKY LAW (1958).

should be sent to the stockholders at least annually. Good working relationships with the underwriter, the stockholders, and the securities markets are of importance. As the company grows, it may need further financing. Antagonistic underwriters and stockholders are not the best source of additional funds.

Often, after the company has put its best foot forward and obtained the necessary funds, there is a period in which earnings not only do not live up to the initial promise, but drop below the latest period included in the registration statement. In part, this may result from the fact that management has devoted an extraordinary amount of time to the financing, to the detriment of sales and profits. The drop in profits may raise problems concerning continuation of dividends. If the prospectus has included a statement of policy to declare such dividends, their discontinuance will shake the confidence of the stockholders. There is at least a moral obligation, and there may be some legal obligation, of directors to use their best efforts to pay the dividend indicated in the prospectus.

It is of importance that the funds received from external sources be devoted to the stated purposes for which they were raised. The representation in the registration statement (or the representation to the institutional lender) is a matter of importance to which management must adhere. The development of unusual circumstances may at times justify some departure from the initial intention, but that departure must be well based.

After the issue is sold, the underwriter will be responsible for developing a market in the securities. A small issue cannot, of course, be the basis for a broad market, but an active and aggressive syndicate can provide a satisfactory market, even in the case of an issue thought to be small. Generally speaking, over a period of a year or two, the $1,000,000 issue should develop 750 to 1000 stockholders or holders of debt, and sometimes substantially more. With this number, a market with some depth should result.

The small company may wish to consider listing on the American Stock Exchange.[55] As a general rule, the distribution of 100,000 to 125,000 shares among 500 or more stockholders and earnings in the six-figure area will enable the issuer to obtain a listing on the American Stock Exchange. Whether such listing is wise or justified in each case is a matter for consultation between the company and the underwriter. On the one hand, listing may limit activity in the market; commissions on the Exchange are below the trading profits which may be available to the underwriter in the over-the-counter market. Since salesmen seek the most profitable activities for their time, it may be difficult to interest them in the lower commissions. As a result, the market may be a thin one, and a thin market is sometimes worse than none, since it creates the impression of a market price which is not, in fact, a sound one. On the other hand, the underwriter may prefer to have the issue listed on the Exchange for status and recognition, and enhancement of collateral loan values (depending on current margin regulations). There are other advantages to the in-

[55] The requirements of the New York Stock Exchange are beyond most small businesses.

vestor and the issuer in the maintenance of a recognized, orderly market in the stock.

Among the problems that may arise, postfinancing, will be those having to do with expansion by way of merger or acquisition. Once the company has sold its stock to the public, it may find that smaller competitors or suppliers will be interested in joining the organization and merging their businesses so as to achieve the benefit of larger-scale operations. Each such project must be carefully examined and discussed with the underwriter, whose assistance may be required eventually in order to finance the acquisition. Mere size is not, of course, a virtue; a combination of unprofitable businesses does not automatically lead to profits. However, among the benefits of the financing may be the ability of the issuer to expand more quickly by acquisition of businesses not large enough to do their own financing, but important enough to add to the profit and growth potential of the company.

VIII

SMALL BUSINESS INVESTMENT ACT

To supplement prior sources of equity capital and term loans for small business, Congress adopted the Small Business Investment Act of 1958, which became effective on August 21, 1958. It is the declared purpose of the Act[56]

> to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply.

The Administration is now establishing its operation, mechanism, and policies. At this point, it is possible only to sketch the framework of the statute and of the regulations adopted to implement it.[57]

In general, the Act and rules permit the licensing by the Small Business Administration (SBA) of "small business investment companies" to provide funds to "small-business concerns" through the purchase of convertible debentures (which are considered equity securities) and securities evidencing long-term loans. The SBA will examine and supervise the operations of its "licensees," which may borrow funds (under specified conditions and circumstances) from the SBA and private sources. An aggregate of $250,000,000 of loans by the SBA to investment companies may be outstanding at one time, but only $50,000,000 may be borrowed by the SBA from the Treasury during the first year of operation, and an additional $100,000,000 during the second year.

A. "Small-Business Concerns"

The ultimate borrower or issuer under the Act is the "small-business concern." Such a concern is defined by the original Small Business Act as "one which is in-

[56] 72 STAT. 689, 15 U.S.C.A. § 661 (Supp. 1959). [57] 23 FED. REG. 9383-91 (1958).

dependently owned and operated and which is not dominant in its field of operation."[58] The Regulations of the SBA under the new Act provide further:[59]

> A parent company must be considered together with all of its affiliates in determining its eligibility as a small business concern. If a concern is a wholly-owned subsidiary of another concern or is under its control or is under its potential control, it shall be considered an affiliate, and a concern may be an affiliate of another concern if both are owned or controlled by a third party.

A controlled affiliate is not deemed to be independently-owned. This provision of the definition may pose problems in the case of a corporation owned by a person who operates his business on a multicorporation basis, for tax or operating reasons. Only the controlling entity would be eligible for loans.

A concern is not considered small if its stock has a public market or if it has obtained public financing in excess of $300,000 within the past three years. A business concern which has no public market for its securities is not considered small if its total assets (including those of its affiliates) are more than $5,000,000 or if "its total income after taxes, together with all of its affiliates, has averaged over $150,000 per annum during the preceding three years as reported to the Internal Revenue Service." Exceptions from these limitations may be made by the SBA on application.[60]

B. Equity Capital and Term Loans

Under the statute, capital is to be provided "only through the purchase of debenture bonds (of such concern)" which are convertible at the option of the holder into stock at "sound book value" determined at the time of the issuance of the debentures.[61] "Sound book value" is the value per share based on "consideration of all pertinent factors, including the actual value of the assets of said small business concern and the relationship of the earnings of such concern to its invested capital."[62] Interest rate and other terms, including maturity date, may be fixed by the parties, but interest may not exceed the legal limit (or, where no such limit exists, the maximum set forth in the original "proposal" and approved by the SBA).[63] The debentures are to be callable on any interest payment date at face, plus accrued interest.[64] There appears to be no prohibition against convertible debentures subordinated to other securities or claims.

[58] 72 STAT. 384, 15 U.S.C.A. § 632 (Supp. 1959).

[59] § 107.103-1, 23 FED. REG. 9384 (1958).

[60] *Ibid.* Heretofore, the Administration's standards for determining whether a firm is small have related primarily to size of employment. Under 250 employees, a concern has been prima facie considered a small business concern, and over 1,000, a large business concern. In between, standards have varied from industry to industry. The Administration has also classified as small, wholesale concerns with total sales of $5,000,000 or less, and retail or service trades with sales or receipts of $1,000,000 or less.

[61] Small Business Investment Act of 1958, § 304(b), 72 STAT. 693, 15 U.S.C.A. § 684 (Supp. 1959).

[62] § 107.304-1(d), 23 FED. REG. 9389 (1958).

[63] § 107.304-1(f), *ibid.*

[64] § 107.304-1(b), *ibid.*

The investment company may provide that a small business concern shall not incur any further indebtedness without the approval of the investment company, which shall have the first opportunity to finance such additional indebtedness (except short-term credit or open-book loans). The issuer of capital debentures is required to invest from two to five per cent of the proceeds of the issue in stock of the investment company; and such stock may not be repurchased by the investment company so long as it is indebted to the SBA.[65]

In addition to convertible debentures, the small business concern may obtain funds from the investment company by term loans.[66] Such loans are to have a maturity of not less than five years, nor more than twenty years (with a possible ten-year extension), but loans for terms less than five years may be made when necessary to protect prior investments. The loans are required to be "of such sound value, or so secured, as reasonably to assure repayment." This may be interpreted to preclude subordinated loans. The lender may not, as a condition of such loan, acquire any stock or other proprietary interest in the borrower, except through the medium of collateral security. Hence, this section of the Act may not be used as a substitute for the capital debenture provisions. As in the case of the convertible debentures, interest rate is not fixed, but may not exceed the local statutory limit (or, where there is no such limit, the maximum approved by SBA).

Although the conditions of all term loans and debentures are, in general, subject to SBA approval, the Administration has indicated that it intends to permit the parties to negotiate their own terms, within the framework of the policy and program which form the basis of the original license. Only major variations from such basic terms will require specific SBA approval.[67]

Unless the Administration shall otherwise approve, the aggregate amount of debentures and loans of any small business concern acquired by a small business investment company may not exceed twenty per cent of the combined capital and surplus of the small business investment company.[68] Transactions may, however, be undertaken in conjunction with other financial institutions, including other investment companies.

C. Small Business Investment Companies

Loans and investments are to be made by small business investment companies which are to be organized under the laws of the state (or one of the states) of operation, where possible. In certain cases, a federal charter may be granted, but such charters will probably be issued only rarely.[69]

The regulations of the SBA specify in some detail the provisions of an investment company charter. Each company is to conduct its operations in a specified area (but

[65] § 107.304-1(g), (h), (i), *ibid.*

[66] § 305, 72 STAT. 693, 15 U.S.C.A. § 685 (Supp. 1959).

[67] § 107.304-1(i), 23 FED. REG. 9389 (1958).

[68] § 107.306-1(a), *id.* at 9390.

[69] § 301(a), 72 STAT. 691, 15 U.S.C.A. § 681 (Supp. 1959). Chartering under the Small Business Investment Act of 1958 will involve problems of federal incorporation not within the scope of this article.

there is no limitation on the area from which it may draw business). The investment company will be authorized not only to make loans and purchase convertible debentures, but to provide consulting and advisory services on a fee basis. Business may be generated and loans and investments may be investigated and serviced through, or in cooperation with, banks and other financial institutions.[70]

The Act provides that investment companies may be formed by any number of persons not less than ten, and shall have nine directors.[71] The Regulations provide, however, that an investment company which receives its charter from a state shall conform to the laws of such state with respect to the number and qualifications of incorporators and directors, whereas an investment company that receives an SBA charter shall adhere to the standards of the Act.[72]

In order to form a small business investment company, the organizers or "proponents" must file a proposal with the SBA, including a description of proposed investment and loan policies, and data regarding charter, bylaws, officers, directors and principal stockholders, and similar matters. The proposal must establish need in the proposed operating territory, and by concerns of the type intended to be assisted by the investment company. The proponents must also include a plan acceptable to the SBA for expansion of the resources of the investment company by sale of securities to investors.[73] Once the proposal is approved, an application in specified form must be filed, on which the permit is based.[74] Investment policy, borrowing and capital expansion plans, and officers, directors, and principal stockholders may not be changed without SBA approval.[75]

No investment company may commence business without at least $300,000 in capital and surplus.[76] The Act provides that the SBA may purchase subordinate debentures to the extent of one-half of such initial capital; and that such debenture capital is to be deemed a part of the capital and surplus of the company for specified purposes, including loan ratios.[77] An investment company licensed to operate by the SBA may borrow up to fifty per cent of its capital and surplus (including such capital debentures) from the SBA. It is intended that government funds shall be available only to the extent that funds are not obtainable from private sources, but unavailability of private funds may be established by certificate of the investment company.[78] The ratio of outstanding indebtedness to paid-in capital and surplus (including subordinated debentures) may not exceed four to one.[79]

The debentures and other debt securities issued to the SBA by the investment company are to mature in twenty years, bear interest at five per cent, and be amortizable in the second half of the term.[80] Investment companies will be required

[70] § 107.301-1, 23 FED. REG. 9386-87 (1958).
[71] § 301, 72 STAT. 691, 15 U.S.C.A. § 681 (Supp. 1959).
[72] § 107.301-3(a), 23 FED. REG. 9388 (1958).
[73] § 107.201-2, *id.* at 9385.
[74] § 107.201-3, *ibid.*
[75] § 107.308-7(c), *id.* at 9391.
[76] § 107.201-5(c), *id.* at 9385.
[77] § 302(a), 72 STAT. 692, 15 U.S.C.A. § 682 (Supp. 1959).
[78] §§ 107.301-1(c), (d), 107.303-a(a), 23 FED. REG. 9388 (1958).
[79] § 107.303-1(a), *ibid.*
[80] § 107.302-1(e), *ibid.*

to use SBA term loans as a revolving fund, making repayments when possible and reborrowing when funds are needed.[81] Without SBA consent, an investment company may not make investments in or loans to small business concerns having a common officer, director, or ten per cent stockholder (nor advance funds to any officer, director, or ten per cent stockholder of the investment company).[82]

No government funds may be obtained by an investment company unless its executive and at least three directors certify, among other things, that the capital of the investment company is not impaired. Impairment is declared to exist when deficit exceeds either paid-in surplus or fifty per cent of combined capital and paid-in surplus. This may involve problems of investment valuation of considerable difficulty. The certificate must also state that the funds are to be employed in accordance with the Act within thirty days after receipt.[83]

D. Development Companies

The Administration is also authorized to make loans to state and local development companies. Such loans are to be on a secured basis and are to be used for relending or other assistance to identifiable small business concerns and for a sound business purpose approved by the SBA. Loans are limited to $250,000 per small business concern. Lending to local development companies is to terminate on June 30, 1961.[84]

E. Tax Benefits

The 1958 tax acts[85] added three new provisions to the code governing losses on investments in small business concerns and small business investment companies.[86] An investor in the stock of a small business investment company organized under the Small Business Investment Act can take as an ordinary loss deduction (rather than as a capital loss) all losses resulting from investment in such stock, and the losses are considered as attributable to the trade or business of the taxpayer. Certain technical restrictions surround this provision, but in general, it permits the investor to write off his stock in a small business investment company as a business expense, without limitation as to amount.

The investment companies can take as an ordinary loss deduction (rather than as a capital loss) all losses realized from worthlessness, sale, or exchange of the convertible debentures (including stock received on conversion) purchased under the Act. This provision does not, however, apply to losses incurred as a result of term loans made under section 305 of the Act. The Internal Revenue Code further provides that investment companies may take as a deduction 100 per cent of the dividends received from a taxable domestic corporation, rather than the ordinary

[81] § 107.303-3, *ibid.*
[82] § 107.303-3, *ibid.*
[83] § 107.308-1, -2, *ibid.*
[84] §§ 501.02, 72 STAT. 696-97, 15 U.S.C.A. § 696 (Supp. 1959).
[85] The Technical Amendments Act and Small Business Revision Act of 1958, 72 STAT. 1676 (codified in scattered sections of 26 U.S.C.).
[86] INT. REV. CODE OF 1954, §§ 1242-44.

eighty-five per cent credit. An investment company may be classified as a personal holding company under certain circumstances.

Any individual investor in common stock of a small business concern may take as an ordinary loss attributable to his trade or business a loss resulting from such investment. This benefit is allowable only to the original stockholder, and not to a transferee. The maximum allowable to a single investor as an ordinary loss in any one taxable year is $25,000; and on a joint return, $50,000. A small business concern for this purpose is one which offers common stock (for a period of not more than two years) for money or property, pursuant to a plan adopted after June 1958, if, at the time of the adoption of the plan, the sum of the proposed offering (plus other amounts received from stock after July 1, 1958) does not exceed $500,000 and the aggregate capital including the offering does not exceed $1,000,000.

F. Securities Regulation

Securities offered by small business investment companies will be subject to registration under the Securities Act of 1933 and Trust Indenture Act of 1939,[87] except where the respective acts provide exemptions. The principal exemptions from the Securities Act are those relating to issues under $300,000,[88] intrastate offerings,[89] and private offerings.[90]

The Securities and Exchange Commission has published a proposal to adopt Regulation E, extending to small business investment companies the $300,000 exemption of the Securities Act of 1933. The Regulation is similar in form to Regulation A and would apply to public offerings of small business investment companies not exceeding $300,000.[91]

The exemptions provided by the Securities Act of 1933 would be applicable equally to small business investment companies. The Small Business Investment Act of 1958 provides that each issuer of convertible debentures must invest two to five per cent of the proceeds obtained from the investment company in stock of the latter;[92] but the Securities and Exchange Commission has published a proposed rule[93] to extend the private offering exemption to such transactions.

Generally, securities and transactions exempt from the Securities Act of 1933 are also exempt from the Trust Indenture Act of 1939. In the few instances where the Trust Indenture Act of 1939 applies independently, the problem of compliance is not one of major significance. Of more importance are the provisions of the Investment Company Act of 1940,[94] under which the SEC supervises the transac-

[87] 53 STAT. 1149, 15 U.S.C. § 77aaa *et seq.* (1952).
[88] § 3(b), 48 STAT. 76-77, 15 U.S.C. § 77c(b) (1952).
[89] § 3(a)(11), 48 STAT. 75-76, as amended, 15 U.S.C. § 77c(a)(11) (1952).
[90] § 4(1), 48 STAT. 77, 15 U.S.C. § 77d(1) (1952).
[91] Securities Act Release No. 4005, Dec. 17, 1958.
[92] § 304(d), 72 STAT. 693, 15 U.S.C.A. § 684 (Supp. 1959).
[93] Rule 151 under the Securities Act (and Rule N-3C-1 under the Investment Company Act), Securities Act Release No. 4015, Jan. 13, 1959. [After this article had gone to press, both of these Rules were formally adopted. Securities Act Release No. 4033, Feb. 13, 1959. Ed.]
[94] 54 STAT. 789 (1940), 15 U.S.C. § 80a-1 *et seq.* (1952).

tions of investment companies. That Act was adopted originally to protect investors in the extensive operations of companies which are primarily public investment media, but it appears to be applicable to small business investment companies, unless a specific exemption is available.[95]

Section 3(c)(1) of the Investment Company Act of 1940 provides that any "issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities," is not subject to regulation under the Act.[96] Under the SEC's proposed rule, sales of stock by the investment companies to the small business concerns, required by the Small Business Investment Act, would not constitute such a public offering; and an investment company would not be subject to the Investment Company Act until its stockholders numbered more than 100 or until it made a public offering of its securities.

Section 307 of the Small Business Investment Act of 1958 provides that the Securities and Exchange Commission may exempt from the provisions of the Securities Act of 1933, and of the Trust Indenture Act of 1939, any class of securities issued by a small business investment company.[97] The Commission also has broad exemption authority under the Investment Company Act of 1940.[98] No special exemptions have yet been granted or proposed for small business investment companies, except Regulation E and Rule 151.

The power of the SEC to grant special exemptions applies only to securities of the small business investment company, and not to securities purchased by the investment company from the small business concern. The sale by the small business concern to the investment company of its convertible debentures or term obligations for investment would ordinarily be a private transaction exempt under the provisions of the Securities Act of 1933. However, if in the original proposal to the SBA it is stated to be the policy of the investment company to redistribute all securities of small business concerns to the public as soon as practicable, the private offering exemption may not apply.

Resales of the convertible debentures will involve other Securities Act problems. Ordinarily, securities exchanged by a corporation with its existing security holders exclusively are exempt from registration.[99] However, the Commission has recently interpreted the Act to preclude an exemption where the conversion privilege is exercised for the purpose of making a public offering of the underlying stock.[100]

[95] "The bill provides also that, with one exception, the Investment Company Act of 1940 shall apply to small-business investment companies just as it does at present to other investment companies." SENATE REPORT 13. The Small Business Investment Act of 1958, § 307, 72 STAT. 694, 15 U.S.C.A. § 687 (Supp. 1959), exempts investment companies from certain provisions of the Investment Company Act of 1940.

[96] 54 STAT. 798, 15 U.S.C. § 80a-3(c)(1) (1952).

[97] 72 STAT. 694, 15 U.S.C. § 687 (Supp. 1959).

[98] § 6(c), 54 STAT. 802, 15 U.S.C. § 80a-6(c) (1952).

[99] Securities Act of 1933, § 3(a)(9), 48 STAT. 75-76, as amended, 15 U.S.C. § 77c(a)(9) (1952).

[100] *Cf. In re* Gilligan, Will & Co., Securities and Exchange Act Release 5689, May 7, 1958, where the Commission stated: "Quite apart from the question whether Gilligan and registrant originally intended to sell the 1955 debentures when they acquired them from Crowell-Collier, it is clear that when they con-

It may also be concluded that any public distribution of convertible securities involves a public offering of the underlying stock by the issuer. In such event, registration would be required in every case of public sale of debentures or underlying stock, except (absent control problems) where the investment company (or its nonpublic transferees or associates) exercised the conversion privilege and held the underlying stock for investment, making a public distribution of such stock later only under conditions not inconsistent with the original investment intention.

Problems of seeming conflict between state securities and corporation laws and the new Act will arise. It will take some time before such problems can be considered and conflicts resolved. Early conferences with state securities commissioners and other affected agencies may be in order.

G. Appraisal of the Act

The Small Business Investment Act of 1958 has been greeted with great enthusiasm; by November 1958, thousands of inquiries and some "applications" had been received by the SBA. Part of this interest may be traced to stories in the press which have created the impression that the Act may be a "get-rich-quick" device for use by "smart money" with little risk.[101]

It is too early to arrive at definitive conclusions with respect to the method, scope, and effect of the operations of small business investment companies, but a preliminary examination of the statute and its proposed administration hardly supports the popular impression.

Investment in small business is recognized as one of the most speculative areas of financial endeavor. The statute does not solve or ease the problem of finding and developing profitable investments. The success of the enterprise will depend, to a large extent, on the acumen of its management; and the finding of experienced personnel will pose a major problem.

Further, unless the investment company is of considerable size and efficiency at inception, its income from interest, dividends, and fees, at least in the early years, will probably not exceed substantially the costs of administration. The experience of other venture-capital enterprises would indicate that substantial profits, if realized, will result primarily from capital gains.[102]

The attraction of investment in small enterprises has heretofore been limited and, as a result, a substantial gap has existed in the financial sources available to the

verted those debentures into common stock, they acquired such stock with a view to distribution. On this ground, they could be considered statutory underwriters with respect to such stock. Section 3(a)(9) of the Securities Act provides an exemption where an issuer exchanges securities with its existing security holders exclusively, but would not provide an exemption with respect to subsequent public distribution by a recipient who is a statutory underwriter."

[101] See, *e.g.*, Business Week, Oct. 11, 1958, p. 23; Wall Street Journal, Nov. 13, 1958, p. 1.

[102] Mr. Robert Linton, Partner in the Stock Exchange firm of Burnham & Co., and Mr. C. Wrede Petersmeyer, Partner in the firm of J. H. Whitney & Co., leading venture-capital firm, both expressed the opinion, based on extensive experience in the venture capital field, before "briefiing sessions" of the American Management Association held in New York on Dec. 1 and 2, 1958, that at least in the early years, the investment companies would do well to "break even" on a day-to-day basis.

small business manager. If the small business investment company is now to fill that gap (or a part of it), it must be by reason of special advantages not heretofore available. The two most important of such factors are "leverage" and tax savings.

1. *Leverage*

A "leverage" position is achieved by common stock investors when a substantial part of the capital funds needed by the enterprise are supplied by others in the form of fixed return debt or preferred stock investment. In such case, net earnings (and losses) accrue disproportionately to the common stockholders. Under the Small Business Investment Act of 1958, the SBA may purchase a maximum of $150,000 of subordinate capital debentures. It may also lend to an investment company an amount equal to one-half of invested capital (including debentures). Hence, it would be possible to obtain the use of $300,000 of government funds for $150,000 of private investment. In addition, an investment company is permitted to borrow from all sources an amount not exceeding four times its capital. If an investment company with minimum capital funds were able to obtain maximum credit accommodation, initial private investment of $150,000 could be pyramided to $1,500,000 of total funds, with resultant profit leverage (and risk). That leverage possibility has been stressed by the press, but it is highly doubtful that the result described above can be realized in any instance. The lending practices of the SBA have not yet been established, but there is no reason to believe that the Administration will favor those seeking to profit by only minimum investment. Furthermore, it is not realistic to assume that maximum private loans can be obtained until the enterprise has a record of sound and successful investment. The four-to-one ratio of borrowings to capital is only a ceiling and will be based on specific loans and stocks. Credit sources may move slowly to support the new investment company until its portfolio is seasoned. Public investment is apparently to be encouraged, but even here, leverage possibilities will be limited by the standards of investor protection adopted by the SEC and the standards of fairness which will undoubtedly guide the SBA. Some leverage will be achieved, but it is doubtful that it will approach the exciting possibilities described in the press.

2. *Tax Benefits*

An investor in a small business investment company can write off his full investment as a business loss; and the investment company can also charge off its investment losses as business expenses. These provisions are intended to pass on to the ultimate investor tax credits resulting from unsuccessful small business investments. However, to a limited extent, such benefits can be realized without the investment company.[103] Furthermore, in any case where the principal or sole profits of the investment company are capital gains resulting from realization of investments, the tax provisions permitting charge-off of losses against ordinary income may give the company little advantage.[104]

[103] *Cf.* INT. REV. CODE OF 1954, § 1244.

[104] *Cf. id.* § 1312.

3. *Bank Affiliates*

Shares of small business investment companies are eligible for purchase by national banks, and by other banks to the extent permitted by applicable state law.[105] Banks may invest not more than one per cent of their capital and surplus in such stock, and several national banks have expressed interest in forming investment companies, alone or in collaboration with other local banks.

Bank affiliates may have certain advantages, at least initially, over other investment companies. The affiliation would bring prestige and easier access to capital, somewhat easier access to bank customers for investments and loans, and assistance in credit investigation and loan selection. However, the affiliates would also have problems. The experience and standards of the commercial banker are sufficiently different from those of the investment banker to require some orientation in the new field, or supplementary personnel to manage the investment companies. Further, unless the affiliated investment company is to be used as a device merely to make substandard or nonbankable loans at interest higher than bank rates, its success and prospects must be judged by the standards applicable to other investment companies, as discussed above. There is no reason to believe that the operations of the bank affiliates will be substantially more profitable or less speculative than those of nonaffiliated companies.

This type of operation has been thought inappropriate for banks for the past twenty-five years. Whether state banks will be permitted now to operate freely in the field must wait consideration by state banking authorities of the wisdom of such investments; and even in the case of national banks, activities under the new Act will be affected by regulatory policies yet to be established.

H. General

Indications are that the small business investment company may prove an attractive vehicle for persons faced with income taxes in the highest brackets who wish to speculate for capital gains in the development of small business concerns. Such persons may find it convenient to accumulate in the small business investment companies contributions of funds which separately might be insufficient for the purpose. Public funds may also be found. In determining whether to operate under the new Act rather than without it, the entrepreneurs must, however, balance the advantages of leverage and tax benefits against the disadvantage and cost of regulation by the SBA, SEC, and, possibly, state agencies.

From the viewpoint of the small business concern seeking capital, the small business investment companies may prove welcome additions to the ranks of venture-capital providers. The new companies will inject additional capital into the field and will be more easily found. The local community will be able to turn to a recognized enterprise which may become as well known as a bank, instead of shopping for small amounts on a more haphazard basis, as heretofore. But, the limita-

[105] Small Business Investment Act of 1958, § 302(b), 72 STAT. 692, 15 U.S.C.A. § 682 (Supp. 1959).

tions of the source must also be borne in mind. Except, perhaps, in a relatively few instances where the special relationship between borrower and lender makes possible inexpensive administration (and high interest return is a feasible objective) or where trade development and not investment is the principal purpose, the investment companies, as venture-capital enterprises, must make investments which can be liquidated at a capital gain long before the maturity of the debentures. Hence, only concerns which can be developed for ultimate public offering will, in general, find a welcome at the investment company office.

In that connection, the SBA definition of a small business concern to include one with assets up to $5,000,000 and average annual earnings to $150,000 may be important. An examination of prospectuses and offering circulars covering most issues of less than $3,500,000 offered publicly during the past three years indicates that over fifty per cent of such public offerings were made by issuers that would qualify as small business concerns under the definition of the SBA. Such concerns, and those approaching that size, would, of course, constitute the most attractive sources of investments for investment companies. Since the investment companies are to be permitted to solicit the bigger "small business" enterprises in competition with established financial sources, they may be less willing to concern themselves with the smaller and less attractive businesses.

There is, in fact, little reason to believe that the small enterprise below prospective public-offering calibre will find significant help under the new Act. Prospective public-offering calibre cannot be equated with size level, in general, but past experience indicates that few operating companies with assets below the $300,000-$400,000 level will be found with the necessary potential. Hence, one must conclude, well over ninety-five per cent by number of all concerns falling within the "small business concern" definition will not be able to find a solution to their problems under the Act. Such companies account for more than forty per cent of the total assets held by small concerns within the area covered by the definition of the SBA.[106]

IX

CONCLUSION

A significant part of the small business community has access to external capital. Businesses deemed "small" by accepted standards are able to borrow from institutional lenders or to make public and private securities offerings, but they must compete for such capital by outbidding their larger and more experienced competitors.

Size alone usually does not preclude external financing by this segment of the small business community, but such businesses often have disadvantages related to their small size. These include financial inexperience, inadequate management, limited market coverage, volatility of earnings, lack of research and product development, and other similar disadvantages. The small company in an attractive field, with good growth potential, a record of several years operation, and good, alert man-

[106] *Cf.* FEDERAL RESERVE REPORT 167-69.

agement, which has achieved an earnings level in the neighborhood of $100,000 to $150,000 per year, after taxes, can often find private, institutional, or public funds for its capital needs.

Small businesses below the levels discussed in this paper often have no access to external capital. Concerns which own assets amounting in value to less than $250,000 constitute ninety-eight per cent of the number of businesses in the country and account for one-eighth of the country's corporate assets. By almost any standards, such businesses are usually too small to raise external capital; and a good part of those with assets in the $250,000-$1,000,000 range have the same difficulty.

Congress has recently adopted the Small Business Investment Act to fill the gap in the financial resources available to the small businessman. Small business investment companies operating under that Act may constitute a worthwhile addition to the capital market, but it is doubtful that they will solve the problems which face many concerns now lacking access to external capital. Such investment companies may find that the inexorable laws of financial economics require them to adhere substantially to present investment standards if they are to operate as profitable enterprises.

WORKING-CAPITAL FINANCING OF SMALL BUSINESS

Victor L. Andrews,* Seymour Friedland,† and Eli Shapiro‡

Introduction

There are several important suppliers of short-term funds[1] in our financial system. The means used by small concerns to secure short-term financing are associated closely enough with the institutional practice of these lenders that, in large part, the two must be considered together. Therefore, this discussion concentrates upon the financial relationships between small businesses and (1) the commercial banking system, (2) other financial intermediaries, (3) business firms in their lending activities, and (4) specialized financing institutions.

I

The Demand for Short-Term Funds

There are strong incentives for business to finance short-term assets with short-term funds and permanent assets with long-term funds.[2] Lack of access to external long-term debt and equity sources, however, compels small businesses to substitute short-term funds where long-term funds would be preferred. Thus, many small firms are forced to finance permanent assets by continuously refunding short-term debt.[3]

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[1] There is a terminological difficulty inherent in the distinction between short-term financing and financing the total of current assets. Normally, a firm's gross current assets exceed its current liabilities. Necessarily, then, the difference is financed from long-term sources. Since long-term financing lies outside the scope of this paper, we do not discuss this matter. Therefore, it should be understood that short-term financing or working-capital financing here refers to the use of total short-term liabilities to finance a part of current assets.

[2] For representative statements of this notion, see Bion B. Howard & Miller Upton, Introduction to Business Finance 310-14 (1953); Harry G. Guthman & Herbert E. Dougall, Corporate Financial Policy 386-87 (3d ed. 1955).

[3] This observation is substantiated by the results of a survey of member-bank loans to businesses in the Fourth Federal Reserve District. In industries in which small businesses tend to predominate, there was a heavy concentration of continuous borrowing from banks. Thus, in this survey, while only one-third of the amount of notes was over one year old, nearly two-thirds of the dollar volume of commercial and industrial loans was outstanding to borrowers who had been continuously in debt on such loans to the same banks for one year or more. See *Continuous Borrowing Through "Short-Term" Bank Loans*, Monthly Business Review of the Federal Reserve Bank of Cleveland, Sept. 1956, p. 6.

A. Industry Factors in Short-Term Financing

Where technology requires heavy investment by individual firms in fixed assets, the industry is characterized by a high fixed to total asset ratio and a parallel high proportion of long-term funds in the financial structure. Needs for short-term financing are minimal. Conversely, in other industries with less plant and equip-

TABLE I

CUMULATIVE PERCENTAGE DISTRIBUTION OF THE NUMBER OF CONCERNS IN SELECTED INDUSTRIES BY SIZE CLASS[1]

Industry	NUMBER UNDER ASSETS CLASS (thousands of dollars)				
	50	100	250	1,000	5,000
	Per cent				
Manufacturing and Mining					
Food, Liquor, and Tobacco	59.6	75.7	86.4	95.7*	99.0
Textiles, Apparel, and Leather	60.0	75.3	86.5	96.0*	99.2
Metals and Products	47.6	66.1	79.7	92.2	97.7*
Petroleum, Coal, Chemicals, and Rubber	73.3	80.2	89.0	95.9	98.8*
Other Manufacturing and Mining	81.9	89.0	94.5*	98.4	99.7
Wholesale Trade	74.6	84.1	93.9*	98.8	99.8
Retail Trade	90.8*	96.5	99.1	99.9	100.0
Services	97.0*	98.8	99.6	99.9	100.0
Real Estate	68.7	77.3	90.9*	98.4	99.8
Construction	92.3*	95.4	98.6	99.7	100.0
Public Utilities (including transportation, Communication, and Others)	93.3*	95.8	98.3	99.3	99.8

*Denotes proportion in each industry defined as "small."
[1]Sales finance companies were included in original data, but are omitted here.
SOURCE: Stockwell, *What Is a "Small" Business?*, in FEDERAL RESERVE SYSTEM, 85TH CONG., 2D SESS., FINANCING SMALL BUSINESS 150, 162 (Comm. Print 1958).

TABLE II

CUMULATIVE PERCENTAGE DISTRIBUTION OF TOTAL ASSETS OF CONCERNS IN SELECTED INDUSTRIES BY SIZE CLASS

Industry	ASSETS UNDER ASSETS CLASS (thousands of dollars)				
	50	100	250	1,000	5,000
	Per cent				
Manufacturing and Mining					
Food, Liquor, and Tobacco	1.4	3.5	6.7	15.1*	27.6
Textiles, Apparel, and Leather	2.8	6.4	12.3	27.5*	48.9
Metals and Products	.6	1.6	3.3	8.0	17.2*
Petroleum, Coal, Chemicals, and Rubber	.4	.9	2.2	5.3	11.0*
Other Manufacturing and Mining	6.7	11.2	17.3*	29.9	48.5
Wholesale Trade	6.0	13.0	28.7*	51.6	71.6
Retail Trade	29.9*	44.7	59.1	71.6	79.7
Services	34.7*	45.7	57.1	71.2	83.2
Real Estate	12.7	18.1	33.7*	57.7	80.6
Construction	18.2*	26.7	45.8	65.4	82.1
Public Utilities (including Transportation, Communication, and Others)	1.3*	1.9	3.2	4.9	7.8

*Denotes proportion in each industry defined as "small."
SOURCE: Stockwell, *What Is a "Small" Business?*, in FEDERAL RESERVE SYSTEM, 85TH CONG., 2D SESS., FINANCING SMALL BUSINESS 150, 162 (Comm. Print 1958).

ment, the ratio of current to total assets is higher, and a correspondingly greater need for short-term financing results.

Seasonal operations give rise to a demand for short-term funds in many industries. As seasonal needs to carry inventories or extend credit strain cash resources, for example, managers meet these needs with short-term borrowing, which can be readily reduced as the need subsides.

In examining the industrial structure of small businesses in order to gain insights into the effect of their operations and the need for short-term financing, we will use the size and industry classification developed by the Federal Reserve Board for the most recent (October 1957) survey of member-bank loans to business. Table one is a percentage distribution of the number of firms classified by asset size. Table two shows the distribution of assets in each industry among firms in the various size classes. Together, these tables provide an admittedly rough indication of the industries in which the "small"[4] firm is quantitatively important.

These tables illustrate the need for distinguishing the influence upon the demand for funds exerted by the nature of the asset structure of firms within industries and the quantitative significance of small firms within the same industries. For example, in public utilities (including transportation and communication here), heavy plant and equipment requirements make long-term financing the primary demand for funds. Moreover, partly as a result of the need for large-scale operation of heavy fixed investment, small firms are a quantitatively unimportant component of the industry, as indicated in table two. On both counts, then, utilities are not important for the subject of this paper. In distinction, small firms account for thirty-four per cent of the real estate industry's assets, but their asset requirements do not pose particular needs for short-term financing. Typically, real estate firms have a high proportion of fixed to total assets. These assets serve as security for long-term loans, and the financial needs of these firms are fulfilled in this way. Thus, although small firms are significant in the industry, they have no important need to draw upon sources of short-term funds.

Small firms in the trade industry are the largest single group of firms for which a relatively large amount of working-capital financing is consistently needed. Concentration of firms and assets in the lower size brackets is heavy in the trade industry. Almost ninety-one per cent of the firms holding thirty per cent of the assets in the retail trade fall in the $50,000-and-under asset class, defined by the Federal Reserve Board as small for the industry. The $250,000-and-under bracket includes ninety-nine per cent of retail firms, and in the aggregate, they possess fifty-nine per cent of the industry's assets. In the wholesale trade, small firms of less than $250,000 of assets

[4] "Small" here is as defined by the Federal Reserve Board. A primary steel producer is much larger in terms of absolute volume of assets than a haberdasher; yet, both firms may be small in comparison with other firms in their respective industries. The Federal Reserve Board attempted to account for this by designating different asset-size classes as "small" in each industry. These are indicated in the tables. See Stockwell, *What Is a "Small" Business?*, in FEDERAL RESERVE SYSTEM, 85TH CONG., 2D SESS., FINANCING SMALL BUSINESS, 150, 158-63 (Comm. Print 1958) [hereinafter cited as FEDERAL RESERVE REPORT].

held twenty-nine per cent of the industry's assets. Though these tables do not make the comparison, the number of firms in the trade industry bulks large in the business population. Firms in the retail trade made up almost forty-two per cent of the 4,300,000 firms in operation in 1957; and the wholesale trade accounts for another seven per cent.[5] Together, they constitute slightly less than half the entire business population. Thus, roughly one-half of the business population consists of firms for which working-capital financing is quantitatively important.

Demands for short-term funds are subject to seasonal influences in the trade industry. Retail firms especially are affected by holiday influences and the sale of goods connected with seasonal weather changes—for example, clothing, sporting goods, vacation items, and food consumed at certain times of the year.

In general, fixed asset needs are limited in the trade industry, especially the retail segment. Inventory and accounts receivable comprise a large fraction of total assets, and both are financed, in large part, on a short-term basis. We do not have statistics regarding the proportion of accounts receivable in the trade industry to all of nonfarm businesses' accounts receivable, but we do have the figure for inventories. In July 1958, nonfarm business inventories amounted to $85,900,000,000.[6] Inventory of the retail trade and wholesale trade amounted to $24,000,000,000 and $12,100,000,000, respectively, on this date. Since small firms are significant in terms of total assets, it follows that they account for much of this inventory and that their demands for its financing constitute a large part of the demand for short-term funds.

The financing of short-term assets in manufacturing and mining varies among the components of the industry. It is clear that in the aggregate, financing this industry's inventory gives rise to a significant demand for short-term funds, since at the end of July 1958, manufacturing inventories were $49,800,000,000 of a total of $85,900,000,000 of nonfarm inventories.[7]

Large-scale operation in petroleum, coal, chemicals, and rubber tends to concentrate the industry's assets in large firms. Small firms hold only eleven per cent of total assets, as shown in table two, and, moreover, a low proportion of short-term to total assets minimizes short-term financing needs within individual firms. In other lines of manufacturing, small firms are more important. Small firms in textiles, apparel, and leather account for over twenty-seven per cent of industry assets. Small firms held seventeen per cent of industry assets in the metals and metal products and "other" lines of manufacturing. In food, liquor, and tobacco, they held fifteen per cent of total assets; the asset structure of the latter gives rise to short financing needs.

The services industry is comprised mostly of firms in the smallest size category which possess nearly thirty-five per cent of the industry's assets. Many firms in the services industry center their operations about personal services and, as a result,

[5] *Growth in Operating Business Concerns in First Half of 1957*, Survey of Current Business, Jan. 1958, p. 6.

[6] Survey of Current Business, Sept. 1958, p. S-3.

[7] *Ibid.*

need not finance a substantial volume of inventory; an accumulation of accounts receivable, however, may "freeze" a substantial portion of a service firm's funds. Their dependence on short-term financing is evidenced by the industry's high proportion of the number of loans outstanding from the banking system.

Small construction firms account for eighteen per cent of the industry's assets. The construction industry borrows substantially from the commercial banking system.

Small firms tend to utilize short-term loans intensively, in part because of their asset structure. Given two different-sized firms, with a similar proportion of fixed and current assets, the large firm will typically have an advantage in securing long-term funds, because its future income will appear more certain. The small firm, however, has an equal opportunity to secure short-term funds by offering its tangible and assessable current assets as security for these loans, and the practices of the financial system center about the use of this security for loans.

II

WHO SUPPLIES SHORT-TERM FUNDS?

The structure of suppliers of short-term funds is the product of long and continuing evolution in the financial markets. The newer institutions and forms of working-capital financing discussed below are in the forefront of a continuous proliferation in the sources of funds. The commercial banking system is the oldest institutional supplier and today remains the largest single source among these suppliers. Other major suppliers have grown to fill gaps left by the banking system. As the commercial banks indicated unwillingness or inability to assume the risks and administrative costs inherent in certain types of lending, especially to small business, other lenders fitted to absorb these risks and deal effectively with costs of loan management moved in to provide funds.

An essential feature of the growth of new suppliers is their ability to draw upon a range of financial sources in the capital and money markets not available to small industrial borrowers or, if available, to draw upon them on terms more advantageous than the borrower could secure directly. Small firms may be excluded entirely or, if not excluded, must pay higher rates in the financial markets than do large firms and specialized financial institutions. This is explicable in terms of the market's assessment of risk and costs of lending, but it invites arbitrage. Thus, some creditors exploit interest-rate differentials by acquiring funds cheaply and supplying credit on terms better than the market would afford the small borrower. In effect, lenders interpose their credit standing between the financial markets and the industrial borrowers.

The small firm chooses among the alternatives available to it, and through its selection of the most favorable combination of cost and contract terms, encourages growth and efficiency in the financial mechanism. In this way, the history of the financial markets has been one of increasing diversity in the sources and methods of

business finance, with the system continually trying out innovations, accepting some, discarding others.[8]

For interposition to work, it is necessary that some creditors appraise the small firm more favorably than does the over-all funds market. Several things give rise to such divergent views. Experience and familiarity may lead to a favorable credit appraisal. For example, a local bank may have better information than a "foreign" bank about the quality of management or the market prospects of a small business, thereby making the lending risk involved appear smaller than from a distance. This accounts for the local character of bank credit markets for firms which do not have a prime credit standing. In a similar way, a financial institution may have considerable experience in making loans to a particular industry. As a result, it is more willing to lend to a small firm in the industry than would other creditors. A factor which encourages trade creditors to view small firms as credit-worthy is the potentiality of additional operating profits which results from extending credit, and thereby expanding output and sales.

In addition, a variety of lending practices have been developed which reduce risk in the small business loan. These include loans secured by very salable inventory and the financing of accounts receivable. These devices have been associated particularly with the growth of commercial finance companies.

A. Financing through Commercial Banks

Within the constraints of risk and the expense of loan administration, commercial banks, as a rule, cultivate small business accounts. The incentives for them to do this are numerous. Accommodation of the financial needs of small business provides an opportunity for expansion of the deposit resources of the bank and a resulting enhancement of its earning capacity. Small businesses are, in the aggregate, big customers, and many are good credit risks. Indeed, many bankers insist that size of borrower has little bearing in lending decisions.[9]

A distribution by size of borrower of the business loans of the member banks of the Federal Reserve System at October 1957 is contained in table three. Businesses had a total of 1,300,000 loans outstanding, totaling $40,600,000,000. The number and dollar volume of loans was unevenly distributed between sizes of borrowers. Firms of less than $250,000 in assets had taken over three out of four loans outstanding then, but the volume was $6,800,000,000, or only 16.5 per cent of the total. Concerns with assets in excess of $25,000,000 had drawn on the banks for less than one per cent of the number, but over one-third the dollar volume.

1. *Maturity of loans*

The bulk of small business' borrowing from the commercial banks had a maturity of less than one year. In October 1957, for example, fifty-four per cent of the loans to businesses of less than $50,000 assets were short-term; in the $50,000-$250,000 cate-

[8] This evolution is well outlined in N. H. JACOBY AND R. J. SAULNIER, BUSINESS FINANCE AND BANKING (1947).

[9] Eastburn and Balles, *Commercial Banks*, in FEDERAL RESERVE REPORT 396, 402.

TABLE III

BUSINESS LOANS OF MEMBER BANKS BY SIZE OF BORROWER, OCTOBER 1957

Size of Borrower (total assets, in thousands)	Amount of Loans		Number of Loans	
	Billions of dollars	Percentage Distribution[1]	Thousands	Percentage Distribution[1]
All Sizes	$40.6	100.0	1,280.6	100.0
Less than $50	1.5	3.6	504.7	39.4
$50 to $250	5.3	12.9	494.3	38.6
$250 to $1,000	6.3	15.5	157.6	12.3
$1,000 to $5,000	6.7	16.7	48.2	3.8
$5,000 to $25,000	5.9	14.6	13.3	1.0
$25,000 to $100,000	4.9	12.0	5.4	.4
$100,000 or more	8.8	21.7	6.5	.5
Not ascertained	1.2	3.0	50.7	4.0

[1] Detail may not add to totals because of rounding.
SOURCE: Eckert, *Member Bank Lending to Small Business, 1955-57*, in FEDERAL RESERVE SYSTEM, 85TH CONG., 2D SESS., FINANCING SMALL BUSINESS 371, 375 (Comm. Print 1958).

gory, sixty-three per cent of loans were short-term loans. These percentages were somewhat lower than the corresponding ones for intermediate-size businesses. Small businesses tend to draw more heavily on the banking system for term loans than do the medium-size corporations, which have access to the capital markets. The largest firms duplicate the tendency of small businesses to use the banks for term loans, but on a different basis. Whereas small businesses resort to term loans because they lack alternatives, large borrowers frequently use this form of financing, on an interim basis, as a source of flexibility in the timing of their issues of long-term securities.

2. *Secured loans and the forms of bank lending*

Large concerns typically borrow from banks on an unsecured basis. The generally lower credit standing of small businesses has led to the development of an extensive variety of loans which incorporate some form of security for the lending bank. In large measure, the possession of suitable short-term assets is a major determinant of the ability of a small business to draw upon the commercial banks. Some lines of business are denied access to the banking system because their assets are not considered adequate collateral. The great variety of loans made by the banking system to small business at once illustrates the extent to which the financial system has gone in accommodating it and the lengths to which small businesses are sometimes pressed to secure funds.

In general, the types of credit available from banks are more extensive in large than in smaller cities, chiefly because of the dominance of the very large banks in large cities. The different forms of credit available fall off sharply with the size of bank.[10] The smaller ones are equipped to handle a smaller variety of loans. Thus, borrowers in large cities enjoy a certain advantage in dealing with banks capable of offering a wider range of loans.

[10] *Id.* at 405.

In October 1957, approximately half the total volume of loans outstanding and two-thirds of the number of loans were secured loans, but the proportions were heavier than this in the smaller-borrower categories. Over seventy-eight per cent of the dollar value and sixty-eight per cent of the number of loans to borrowers with assets of $50,000 and under were secured. Both the percentages of dollar volume and the number of loans which were secured declined steadily with larger borrowers. For firms with $100,000,000 and more of assets, only seventeen per cent of the value and thirty-five per cent of the number of loans were secured.

Data are available on the security for bank loans; we do not have information on the maturity distribution of loans by type of security. There are certain types of secured loans which have short-term maturities. They are:

a. *Loans on consumer paper*. Over three-fourths of a sample of banks interviewed in a recent Federal Reserve System survey of credit and capital sources[11] reported common usage[12] of loans to small business on consumer paper. It seems especially prevalent in smaller banks, and is used, of course, in large part by retail businesses. Auto dealers sell consumer paper to banks regularly too, but not all banks make such loans. Contract terms vary widely, including purchase with and without recourse, repurchase agreements, and other particular stipulations. Equipment dealers sell the paper arising from purchase contracts too, most frequently to medium and larger banks in small and medium-sized communities.

b. *Construction loans*. Construction loans are extended by fewer banks than are loans on consumer paper. Smaller banks in small communities rarely engage in this type of loan. Apparently the technique is not familiar to them, and the loans require more supervision than the smaller banks are equipped to give. Loans are usually made only to borrowers with established deposit relationships. Maturities range widely, but average in the neighborhood of six months.

c. *Inventory loans*. Inventory loans are made frequently by only slightly over half the commercial banks. This is a rather specialized form of lending, involving considerable administrative expense and difficulty. Thus, large banks, with a more extensive administrative apparatus, are more frequent handlers of this type of loan. Businesses get credit for periods extending from demand to one year; the terms average one-half year.

Continuity of markets and reasonable price stability are necessary to make inventory usable as loan collateral. Unfinished or semifinished inventory is generally not acceptable, nor is any item whose resale value is not easily determined. Hence, borrowing on inventory is confined largely to industries whose inventory is readily resalable. Consumer durable goods sellers, including automobiles, appliances, and furniture, farm equipment dealers, the food and textile industries, liquor dealers, and dealers in construction materials are the most likely borrowers. Dealers in perishables and specialized products are virtually excluded.

[11] *Id.* at 404, table 5.

[12] Bankers were asked to respond qualitatively regarding the frequency with which various types of loans were made. The categories were "frequently, occasionally, rarely, or never." *Id.* at 403.

d. *Accounts receivable financing.* This is an increasingly popular type of loan, but as yet, it is made less frequently than any of the three types mentioned above. It is comparatively new to the banking system, which shunned the risk and administrative problems inherent in it for a long time. The success of commercial finance companies in handling this kind of credit spurred its adoption by the banks. Also, it has been asserted that the passage of the Assignment of Claims Act by Congress in 1940, which permitted the assignment of claims against the Government, and lending on this security by the RFC added to the acceptability of this kind of financing,[13] which has been often thought of as stemming from precarious financial circumstances. The V-loan program during the war often involved securing loans by receivables too, and this may have played a role in its spread. Debtors on accounts receivable frequently dislike having their obligations transferred without their knowledge. It has been alleged that the increase in popularity of statutes requiring filing notice of intent to assign accounts has dispelled the stigma of secrecy surrounding the practice[14] and contributed to its growth. Another suggestion is that the pressure of excess reserves in commercial banks during the 1930's forced them to search widely for earning assets, and this kind of loan grew in consequence.

Accounts receivable are assigned to the banks as security in this type of lending, but usually the debtor on the accounts is not notified; he pays the seller of goods as he would otherwise, and the payment is forwarded to the bank. Security of the loan rests upon the collectibility of the underlying accounts receivable. Hence, the banker carefully examines the size, age, diversification of the accounts, and the credit standing of the various debtors. Unlike commercial finance companies and factors, banks have no minimum size requirements of a customer's business necessary to qualify for financing, nor a maximum of a customer's total receivables they will finance. Typically, they will advance seventy-five per cent of the face value of the receivables, but this is dependent on rates charged and varies with individual circumstances.

Credit insurance is an old, but little known, device which seemingly could enhance the ability of small firms to borrow upon the security of their accounts receivable. It protects against bad-debt losses in excess of the normal or primary loss rate experienced by the firm in its past. Two companies are writing this type of insurance in the United States at present, covering an estimated $8,000,000,000 of sales annually.[15]

It seems probable that commercial banks would be more willing than otherwise to lend upon the security of insured accounts receivable, and similarly for commercial finance companies. Indeed, it is possible to obtain riders for these insurance policies allowing the client's bank to file claims against the insurance company.

[13] Zinner, *The Contribution of Commercial Receivable Companies and Factors to Financing Small- and Medium-Size Business*, 2 J. FINANCE 88 (1947); CLYDE WILLIAM PHELPS, ACCOUNTS RECEIVABLE FINANCING AS A METHOD OF BUSINESS FINANCE 61 (1957). *Cf.* 54 STAT. 1029, 41 U.S.C. § 15 (1952).

[14] CREDIT POLICY COMMISSION, AMERICAN BANKERS ASSOCIATION, ACCOUNTS RECEIVABLE FINANCING 2 (1957).

[15] Cloos, *Credit Insurance*, in FEDERAL RESERVE REPORT 480.

However, it is possible for banks to construct their loans to give recourse against the creditor in the event of default upon a receivable, and this is regularly a feature of commercial finance company nonnotification financing. Nevertheless, such insurance should add to the ability of a marginal risk firm or a firm with undiversified or otherwise unsuitable accounts receivable to use them for collateral.

3. *Size and industry of borrowers: economic fluctuations*

Fluctuations in the aggregate level of business activity and in the pattern of demand for final products affect the magnitude and direction of bank borrowing. The industry-size-of-business distribution of loans underwent substantial alteration during the boom in business activity and stringency in the financial markets in the period 1955-57, as is shown in table four. In these two years, total loans to business had expanded by $9,800,000,000, but the industry and size groups of businesses shared unevenly in the expansion. In general, large businesses experienced loan growth disproportionate to their percentages of loans outstanding at the beginning of the period. In October 1955, small businesses in all industries had twenty-one per cent of

TABLE IV

DISTRIBUTION OF THE INCREASE OF BUSINESS LOANS OF MEMBER BANKS, 1955-57, BY BUSINESS AND RELATIVE SIZE OF BORROWER[1]

Business of Borrower	Increase (millions of dollars)	Increase or Decrease (−), 1955-57 Percentage of Industry Total by Size of Borrower[2]		
		Small	Medium	Large
All Businesses	$9813	6.9	39.5	50.4
Manufacturing and Mining:				
Food, Liquor, and Tobacco	523	10.0	6.2	83.7
Textiles, Apparel, and Leather	−53	−154.4	−95.3	157.1
Metals and Metal Products	2285	16.6	32.0	51.4
Petroleum, Coal, Chemicals, and Rubber	1147	13.0	14.5	68.0
Other Manufacturing and Mining	895	2.1	58.9	38.0
Trade:				
Retail Trade	1144	1.4	56.9	38.9
Wholesale Trade	590	16.0	48.4	37.2
Commodity Dealers	79	7.4	12.7	78.7
Other:				
Sales Finance Companies	263	− 2.7	74.9	27.1
Public Utilities (including Transportation and Communication)	1334	1.1	53.6	39.7
Construction	289	− 3.5	27.9	62.8
Real Estate	546	4.1	23.5	52.6
Service Firms	499	2.8	56.7	41.4
All Other	272	2.1	41.7	46.5

[1]For classification of borrowers by size, see *supra* note 4 in the text.
[2]Figures do not add to 100%, because some loans were made to borrowers whose size was not ascertained.
SOURCE: Eckert, *Member Bank Lending to Small Business, 1955-57*, in FEDERAL RESERVE SYSTEM, 85TH CONG., 2D SESS., FINANCING SMALL BUSINESS 371, 375 (Comm. Print 1958).

the loans outstanding; medium-sized borrowers had forty-five per cent; and large[16] borrowers, thirty-two per cent. In the expansion of the following two years, however, small businesses in all industries got slightly less than seven per cent of the *increase*, while medium-size businesses claimed almost forty per cent, and large businesses over half.

Changes in the demands for final products played a significant role in the pattern of bank lending to small business. Industries dominated by large firms received the largest part of the banks' loan growth in this period. The following industries—metals and metal products, petroleum, coal, chemicals, rubber, and public utilities—received over half the expansion in loans to large businesses. This concentrated growth is attributable to several factors:[17] (1) in general, large businesses account for a preponderance of output in these industries; (2) these industries experienced some of the largest increases in demand for their final products in this period, some of the greatest increases in output, and also, with the exception of public utilities, some of the sharpest rises in product prices; and (3) capacity, including working capital, was expanded sharply in these three industries.

A large part of the working-capital growth of large corporate bank borrowers was represented by an increase of net accounts receivable. Since large corporations tend to be net creditors of smaller corporations and the unincorporated universe, this growth of net receivables may have served as financing for the latter in place of added bank borrowing.

In the retail trade, small firms received an extremely small part of the industry's total growth in loans, but medium-sized firms received almost fifty-seven per cent of the increase. In the wholesale trade, small firms received sixteen per cent of the industry's loan increase. In the services industry, medium-sized firms, again, received well over half the industry's expansion, and firms in the smallest size bracket claimed an almost negligible share.

Small firms in construction and textiles, leather, and apparel actually experienced declines in loans outstanding. The situation in construction in this period is explained by a decline in home building, in which small firms predominate, and an increase in industrial and commercial construction projects, often suitable only for large firms. Over-all depression of activity is probably responsible for the net decline of bank loans to small firms in the textile industry. Indeed, the industry total of bank borrowing declined in this period.

B. Other Intermediaries and Governmental Sources

A certain volume of funds are procured from other intermediaries by small businesses through the use of collateral unrelated to the business. We know little of its ultimate use that is definite, but it seems certain that some is devoted to short-

[16] Again, we are employing size definitions of the Federal Reserve Board, and they differ according to the size pattern of enterprises characteristic of that industry. See Eckert, *Member Bank Lending to Small Business, 1955-57*, FEDERAL RESERVE REPORT 371.

[17] *Id.* at 379.

term purposes. The most significant of these intermediaries are the mortgage lenders. Small businessmen faced with great difficulty in securing funds from the banking system and the specialized financing institutions sometimes mortgage their residential real estate to life insurance companies or savings and loan associations, and utilize the funds gained in their businesses.[18] Similarly, a certain portion of the policy loans made by life insurance companies ultimately is used by small businesses for short-term purposes. Again, however, we have almost no quantitative information. It has been pointed out[19] that the volume of reserves held against life policies by the insurance companies appears to be a source of funds ill-developed by small business. At the end of 1956, for example, outstanding policy loans represented only six per cent of the reserves maintained to guarantee fulfillment of life insurance contracts. The interest rate on policy loans is contractual, and its differential from other money rates becomes favorable in times of tight money; yet, the volume of loans outstanding is not sensitive to interest-rate fluctuation.

A certain portion of the bond and commercial mortgage loans made by life insurance companies goes to small businesses. The volume going to a small business, however, is not significant and is predominantly long-term in character. The annual dollar volume of loans less than $250,000 in size was $278,000,000 for the period 1953-56 by life companies controlling seventy-seven per cent of the industry's assets. The web of state laws surrounding investments by the life insurance companies prevents them from becoming lenders to small business, and there is little prospect of a fundamental change in this situation.

A number of governmentally-sponsored small business loan programs have been adopted at times in the past, and some continue now.[20] Most of these programs have made available medium-term loans. The programs have attempted to make funds available for working-capital purposes. Federal Reserve loans to businesses were confined by statute to working-capital purposes. Roughly one-third of the loans made by the RFC were used for this purpose, and thirty-six per cent of the loans authorized by the Small Business Administration have been for working capital. Quantitatively, the contribution of governmental loan programs to small business has not been large. The combined volume of SBA and VA business loans and commitments outstanding at the end of 1955 was equal to only two per cent of the small business loans outstanding at member banks.

C. Interbusiness Financing

Interbusiness financing is the extension of credit by one nonfinancial business to another, usually from seller to buyer.[21] Merchandise vendors often view credit

[18] LIFE INSURANCE ASSOCIATION OF AMERICA, SURVEY OF LIFE INSURANCE LOANS TO BUSINESS AND INDUSTRY 5, table 2 (Joint Investment Bull. No. 321, 1957). See also Klaman, *Life Insurance Companies*, in FEDERAL RESERVE REPORT 512, 518.

[19] Andrews, Friedland, and Shapiro, *Who Finances Small Business?*, in FEDERAL RESERVE REPORT 20, 34.

[20] For a comprehensive review of governmental programs, see Arlt, *Governmental Loan Programs for Small Business*, in FEDERAL RESERVE REPORT 253.

[21] Einzig, *Credit from Large to Small Business*, in FEDERAL RESERVE REPORT 482, 483.

to a small business more sympathetically than financial institutions. One reason for this is that the selling firm expects to stimulate sales by extending credit, relying on added profits to offset the risk and costs of the loan. Another explanation is that the seller may have to choose between financing independently-owned distributors or operating his own distribution system. Should he choose the latter, he may have to supply the bulk of the operation's financial requirements as well as shoulder the nonfinancial risks entailed in the operation of the integrated distribution system. In much of trade credit, the cash expenditure of the seller is less than the credit received by the buyer, because the price of the merchandise includes profit and noncash expenses, such as depreciation.

Most interbusiness financing takes the form of trade credit, in which merchandise is sold on credit terms, with only a ledger account to indicate the debt. Other forms include merchandise sales where customer indebtedness is evidenced by notes or trade acceptances, customer's receivables or installment paper, "floor plan financing" of inventory in dealer's hands for periods longer than ordinary trade credit, and advance payments to suppliers for merchandise.

1. *Trade credit*

a. *The volume of trade credit.* Accounts receivable are a reasonably accurate measure of credit extended, and accounts payable contain mainly trade debt, and, therefore, we can look upon them as gauges of the volume of trade credit outstanding. Table five presents trade payables as a percentage of all sources of funds for various classes of firms. The data show that manufacturing corporations depend more heavily upon trade credit than does the corporate universe, and, more significant for our discussion, that small firms are more dependent upon trade credit than are large.

TABLE V

ACCOUNTS PAYABLE FOR NONFINANCIAL CORPORATIONS AND MANUFACTURING CORPORATIONS, BY SIZE OF FIRM, AND FOR THE NONFARM, NONCORPORATE BUSINESS SECTOR

	Accounts Payable	
	$ Billions	% of Total Liabilities
All Nonfinancial Corporations[1]	$40.0	14.8%
Nonfinancial Corporations with Assets Less than $250,000[1]	6.4	31.5
All Manufacturing Corporations[2]	15.8	23.6
Manufacturing Corporations with Assets Less than $250,000[2]	1.2	45.6
Nonfarm, Noncorporate Business Sector[3]	11.0	19.8[4]

[1] INTERNAL REVENUE SERVICE, STATISTICS OF INCOME pt. 2 (1955).
[2] FTC-SEC Quarterly Financial Report for Manufacturing Corporations, 4th quarter 1955.
[3] 43 FED. RES. BULL. 1194 (1957).
[4] The nonfarm, noncorporate sectr includes data for unincorporated real estate firms and individuals with real estate portfolios. As a result, mortgages for the entire sector account for $25,800,000,000, or 46% of total liabilities. While it is impossible to distinguish between mortgages held by real estate firms and the mortgages of the properties of other unincorporated firms, the real estate group undoubtedly accounts for the bulk of mortgages. If the mortgages plus $3,200,000,000 of bank loans made to unincorporated real estate firms are removed rom the sector, accounts payable become 41.4% of the remaining liabilities.

While trade credit is the most important short-term source of funds for the universe of manufacturing corporations, it is only slightly larger than accrued taxes. However, for manufacturing firms with assets less than $250,000, trade credit is about four times larger than the second most important short-term source. For noncorporate, nonfarm businesses, trade credit and bank credit are about equally important, after the adjustment for unincorporated real estate firms, shown in note four, table five.

In the decade following World War II, trade credit was about four per cent of the total sources of funds of the Federal Reserve Board's sample of 300 large corporations. In contrast, trade credit constituted about thirteen per cent of the total sources for all other corporations.[22]

b. *Trade credit and size of firm.* The ratio of trade receivables to trade payables is a measure of the extent to which a firm is a net trade creditor. If the firm receives more trade credit than it extends, payables will exceed receivables and the ratio will be less than one, and conversely. Between 1951 and 1957, all manufacturing corporations were net trade creditors. The ratio of receivables to payables averaged 1.8 over the period.[23] However, except for firms with assets in excess of $100,000,000, the receivables/payables ratio declined with the size of firm. For example, manufacturing firms with assets less than $250,000 had a receivables/payables ratio of only 1.2 over the period.

A recent analysis of the receivables/payables ratio by industry and firm size for the corporate universe indicates that trade credit tends to flow from large firms to small firms.[24] Very small firms, and, undoubtedly, most unincorporated enterprises are net trade debtors. These findings are consistent with the thesis that large firms effect a transfer of funds between the capital markets and small enterprises.

During the period 1954-57, bank credit was tightened. At the same time, and perhaps as a result, the proportion of high-risk loans made by banks decreased. The industries most strongly affected were trade, construction, and textiles, which are composed primarily of small firms.[25] Thus, although bank credit was made less accessible generally, it appears that the small firms were rationed more severely than large ones.

During this period of stringency in the supply of funds from the banking system, trade credit expanded. Data in the Quarterly Financial Report for Manufacturing Corporations showed a substantial increase in net trade credit during 1955 and 1956.[26] The increase in trade credit extended by manufacturing corporations exceeded the increase in bank loans. Firms drew down cash balances to increase the volume of

[22] Andrews, Friedland, and Shapiro, *supra* note 19 at 23.

[23] FTC-SEC Quarterly Financial Report for Manufacturing Corporations, 4th quarter 1951-4th quarter 1957.

[24] *Trade Credit: A Factor in the Rationing of Capital,* Monthly Review of the Federal Reserve Bank of Kansas City, June 1957, p. 3.

[25] *The Price of Business Loans,* Business Conditions, Monthly Review of the Federal Reserve Bank of Chicago, March 1957, p. 14.

[26] *Trade Credit: A Factor in the Rationing of Capital, supra* note 24, at 5.

trade credit. The velocity of money was raised in this way to offset stringency in the money supply. More current data indicate that in 1956, large corporations (trade credit suppliers) increased both bank loans and long-term indebtedness more rapidly than they had in 1955. Small corporations, on the other hand, increased bank loans less in 1956 than in 1955 and decreased the level of long-term indebtedness. In 1955, trade credit represented a *use* of funds for small corporations—*i.e.*, small corporations extended more trade credit than they received. In 1956, trade credit was the single most important *source* of funds for the small corporations.

The behavior of trade credit during this period confirms earlier studies[27] which suggest that larger firms tend to distribute the total supply of funds in the business sector and, thereby, add liquidity to smaller enterprises. The data lend credence to the interposition view of the financial system.

c. *Trade credit terms*

(1) *Availability*. On occasion, minimum orders are required before credit terms are made available.[28] These requirements are usually set low enough as not to bar small business. To assure the seller a practicable amount of business, the requirements may be a minimum purchase order or a minimum level of total sales.

Almost all customers are screened for credit-worthiness before trade credit is extended. However, the standards applied are flexible, since the credit risk is associated with a profitable sale. The credit check involves the use of rating services such as Dun and Bradstreet, the buyer's history with trade credit, statement analysis, personal contact, and the buyer's relationships with commercial banks. Most firms are willing to grant some trade credit to new customers, but restrict the amount until experience has been gained.

(2) *Maturity*. The typical maturity for trade credit is thirty days, but a number of factors cause variations in terms. The ability of a businessman to finance inventory through trade credit depends upon the inventory-turnover period and the length of time credit is extended. If the trade credit maturity equals the inventory-turnover period, the seller supplies the inventory-financing needs of the buyer. If the maturity falls short of the inventory-turnover period, the buyer must finance inventory from other sources for the remainder of the turnover period. If the maturity exceeds the inventory-turnover period, trade credit will finance all inventory needs and be available for other working-capital purposes. Analysis of data from the Robert Morris Associates shows considerable variation in the relationship between credit maturity and inventory-turnover periods in various industries. For example, meat is sold on maximum credit terms of five days, while blanket sales in an off-season period may carry credit for as long as six months.

[27] Jacoby & Weston, *Financial Policies for Regularizing Business Investment*, in REGULARIZATION OF BUSINESS INVESTMENT 369 (1954); C. L. MERWIN, FINANCING SMALL CORPORATIONS IN FIVE MANUFACTURING INDUSTRIES (1942); J. K. BUTTERS & J. LINTNER, THE EFFECTS OF TAXES ON GROWING ENTERPRISES (1945).

[28] The material in this section is taken from Einzig, *supra* note 21, at 484.

Competition plays a role in determining the length of trade credit. During periods of strong competition among sellers, trade credit maturities tend to be lengthened. Also, industries characterized by a large number of firms, such as apparel, leather, and furniture and fixtures, extend lengthier terms than industries characterized by fewer sellers, such as petroleum, chemicals, rubber, and iron and steel. An alternate explanation of this phenomenon may be that those industries with few sellers have large customers with minimal trade credit needs.

Because of the relationship between trade credit extension and profitable sales, the maturity of trade credit is not as sternly enforced as it would be by a purely financial institution.

(3) *Costs of and returns on trade credit.* The costs of trade credit are bound up with its maturity. If payment is made within a specified time, discounts may be taken by the buyer. Although discount terms vary from none in the food and dairy industry to as high as eight per cent in the apparel industry, the most widely quoted rate is two per cent. In order to deduct the discount, the bill must be paid generally within ten or fifteen days. For example, credit terms may be 2/10, n/30, which means that a two per cent discount may be taken if the bill is paid within ten days, but the gross bill must be paid within thirty days. Failure to take the discount is costly. If the buyer waited thirty days to make payment, he would forego a two per cent discount for an additional twenty days of credit, the equivalent of a thirty-six per cent interest rate. However, if the gross maturity were more generous, the cost of foregoing the discount would fall. If the terms were 2/10, n/60, and the buyer waited sixty days before paying the bill, the cost would be equivalent to a 144 per cent annual interest rate.

Although there is variation in credit terms among sellers, most do not discriminate among customers. However, hearsay evidence indicates that credit terms are allowed to vary from formal quotations on occasion. There are many ways for such deviations to occur, but the simplest is when the seller allows a cash discount after the discount period or even after the gross maturity date. This is more subtle competition than price cuts or changes in quoted credit terms, since competitors may be unaware of the change for a time and unable to respond quickly.

Other credit costs may be included in the price of the goods. Since the seller has incurred credit costs (ranging from the interest cost of borrowed funds to the loss of the return from an alternate use of the funds), these may be embedded in the price charged for the product. However, the increase in sales resulting from the extension of trade credit may allow the seller to achieve significant economies of scale or to reduce his inventory storage costs. In this event, the resulting savings may absorb the added costs of extending credit.

That savings may accrue to the seller from the extension of trade credit is indicated by the existence of deferred dating practices. Deferred dating applies usually to seasonal items in which off-season purchases are accorded credit terms for as long as six months. In the sporting goods industry, for example, goods shipped after

December 1 could be for and discount taken to April 10; if shipped after June 1, discount could be taken to October 10; and if shipped between October 1 and December 1, discounts could be taken to January 10. The savings which tend to offset the seller's credit costs are the removal of seasonal variations in production and the reduction of inventory storage costs, as well as increased sales. In nonseasonal goods, deferred datings are used to work off excessive inventories and to encourage large orders.

2. *Receivables financing and "floor planning"*

Financing the buyer's credit sales and inventory needs through the extension of credit by the seller with accounts receivable or inventory as security has grown rapidly.[29] Receivables financing and "floor planning" (financing with customer's inventory as security) are done almost exclusively by very large suppliers. Direct receivables financing is done in the petroleum industry through the financing of consumer credit cards, gasoline sales to farmers, and bulk fuel oil receivables. In the machinery industry, dealers who offer rental or installment terms to their customers have the resulting receivables financed by the manufacturer.

a. *Financial subsidiaries.* Increasingly, companies which engage in accounts receivable financing or "floor planning" do so through a financial subsidiary. It has been estimated that since 1949, fifty financial subsidiaries of nonfinancial companies have been organized. Almost all the parent companies are among the 500 largest industrial firms.[30] Most of the subsidiaries specialize in financing the sale of hard goods, such as motor vehicles and electrical appliances.

Initially, financial subsidiaries are financed largely by the parent company. However, after several years of successful operation, the subsidiary can usually turn to the financial markets on the basis of its own credit standing. Since the business of the subsidiary is related to the sales of the parent firm, the financial subsidiary enjoys an excellent credit rating and has access to funds on favorable terms.

The "floor planning" activities of financial subsidiaries result from an attempt by the selling firm to supplement ordinary trade credit terms in order to finance the customer's entire inventory-turnover period. Regular "floor planning" is usually not done for more than a nine-month period, although renewals are common when merchandise has not been sold.[31] In financing receivables, the time period is ordinarily much longer, averaging three years,[32] and ranging up to seven years for the heavier durable items.

These credit devices are clearly for competitive purposes and are apparently highly successful.[33] The use of the subsidiary reduces the risk to the parent which would result from financing these longer-term needs of customers directly or indirectly.

[29] *Id.* at 489.
[30] Banner, *Competition, Credit Policies, and the Captive Finance Company*, 73 Q. J. ECON. 241, 242 (1958).
[31] Einzig, *supra* note 21, at 490.
[32] *Ibid.*
[33] Banner, *supra* note 30, at 243-48.

While this result could be achieved through arrangements with an independent finance company, the subsidiary can be depended upon to operate with the primary aim of expanding the parent's sales. The independent finance company is more apt to be concerned with the credit-worthiness of the customer.[34] There is also evidence indicating that the financial subsidiaries generate substantial profits to the parent companies purely from financing charges.[35]

3. *Other forms of interbusiness credit*

Other short-term credit devices are largely restricted to marginal credit risks, who, upon receipt of goods, are required to sign formal debt instruments as trade acceptances and notes.[36] However, in some industries, such as furniture and canning, trade acceptances are used for most credit transactions.

Both notes and trade acceptances run typically for ninety days and carry interest rates from five to six per cent. They are also used when trade credit accounts become overdue, or when a customer desires credit above his trade credit limit. Sellers feel that the formal instrument creates more pressure for prompt repayment than does an open book account, as well as constituting a superior legal claim. By and large, notes are used more frequently for these purposes than are trade acceptances.

4. *Social issues*

As was pointed out above, interbusiness financing tends to flow from large (sellers) to smaller (buyers) firms. Since large firms have a financial advantage over smaller firms in securing funds, the existence of interbusiness financing may pose a threat to competition by enabling the larger firm to undercut (either on price or credit terms) the smaller firms which are in direct competition with it. On the other hand, in the customer markets, small firms may not be able to survive in the absence of interbusiness financing. Thus, if trade credit were abolished to improve competition on the sellers' side, it might result in a concurrent decline in competition on the buyers' side by reducing the number of small firms whose existence is dependent upon the availability of trade credit.

D. Financing through Commercial Finance Companies and Factors

Commercial finance companies and factors are important to small business, both because of the volume of financing they handle and because they make funds available to some businesses unable to draw upon the banking system. The bulk of their activity involves the purchase or lending on the security of accounts receivable, sometimes referred to as "credit at the margin" or "lending at the margin." The large finance companies, on the other hand, have access to the nation's financial markets on terms relatively more favorable than their customers. They draw heavily upon the open commercial paper market, and in addition, the large finance companies place

[34] *Id.* at 249-50.
[35] *Id.* at 253.
[36] Einzig, *supra* note 21, at 490.

paper privately; they are preferred borrowers from the banking system with faultless credit records, and they draw heavily on the corporate bond market. Thus, they are wholesalers of funds.

There are several types of specialized finance companies which lend to consumers, to businesses whose customers are consumers, and to businesses whose clients primarily are other businesses. Commercial finance companies and factors engage in the last-named type of financing, and we concentrate upon it here.

Commercial finance companies and factors make short-term funds available through lending on, or the purchase of, open book accounts receivable and on inventory loans. They also make an important and growing volume of funds available for equipment financing, but this is not short-term financing. Commercial finance companies lend or advance money, typically eighty per cent of the face value, on the security of assigned accounts receivable, without notice to the obligor and without assuming risk or the task of collecting on the account. The debtor on the account receivable makes payment in the ordinary way to the seller of goods, who, in turn, pays the finance company. "Factoring" is the outright purchase of accounts receivable, without recourse to the seller and with notice to the obligor, who then pays the factor directly. Here, the risk of default and the job of collection is absorbed by the factor. Again, these functions are generally performed by separate companies, but the separation is not hard and fast. Several companies regularly offer both sorts of arrangements. Accounts receivable financing is not a one-time loan, but involves a continuing relationship between the borrower and the institution, because loans and advances are made on a revolving basis as each sales invoice is assigned or sold, usually daily. The underlying security is the strength of the receivables themselves, and, hence, the finance companies exercise surveillance over the borrower's operations including audits and managerial assistance.

Inventory loans are made almost invariably to regular customers of the accounts receivable trade on the strength of warehouse receipts, factors' liens, and trust receipts. This lending is confined to finished goods and resalable raw materials inventory and excludes goods-in-process. Inventories are usually less desirable collateral for loans than receivables because of the drastic price reductions involved in forced liquidation.

Comprehensive statistics of the number of borrowers and the volume of financing are not available. Estimates indicate that perhaps less than 20,000 firms, with assets between $350,000 and $650,000, are regularly financed directly by these institutions.[37] A sample of thirty of the largest institutions had $512,000,000 of accounts receivable outstanding at the end of 1956, and the volume for the year was $4,600,000,000 on 3,744 borrowing arrangements.[38]

Carrying accounts receivable freezes a firm's funds during the collection period. Receivables financing eliminates the wait for the normal process of turnover to liquidate the account. Thus, the turnover of receivables in the portfolios of finance

[37] Pawley, *Survey of Commercial Finance Companies and Factors*, in FEDERAL RESERVE REPORT 449.
[38] *Id.* at 451.

companies and factors is one measure of the contribution made in financing small firms. The average turnover period based on sales in the thirty-company group was 32.4 days in 1956 for loans on receivables, and 43.1 days for factored receivables.

Several features of the operations of commercial finance companies and factors give small businesses in manufacturing and the wholesale trade better access to this financing than others have. Concerns in these lines usually have products with stable markets, they have average sales invoices of substantial amounts, and they sell primarily to other businesses rather than to consumers. These characteristics give the lender security for his loan and make for transactions sizable enough to be profitable. Firms in the retail industry, however, are virtually excluded because of the absence of the aforementioned features in their operations, and we have seen earlier that over two-fifths of the entire business population centers in the retail trade. Receivables of service organizations are unacceptable, because the product is intangible and the collateral value of the receivable less certain as a result. Construction firms are normally precluded from borrowing against receivables because mechanics' liens and the danger of nonperformance by contractors vitiate the collateral value. Within the two major types of clientele[39] (manufacturing and wholesale trade), there is not a dominant kind of business; firms in an immense variety of product lines use finance companies.

Factoring, on the other hand, is used for the most part by firms in textiles, though in recent years it has spread beyond this industry. The notification feature of factoring appears to limit its spread somewhat, because a great deal of prejudice against it remains among trade customers who apparently prefer strongly to deal only with the vendor or who believe the practice connotes financial difficulties for the vendor. Small invoices and receivables with an uncertain security status, such as receivables in the construction and service industries, are excluded from factoring, as they are from open accounts receivable financing.

Minimum size requirements limit the ability of many small firms to utilize finance companies and factors. Clearly, a certain volume of business is requisite to make an account a paying proposition for the lender; and, consequently, these institutions impose minimum sales requirements, and/or requirements for minimum amounts of credit outstanding, and occasionally minimum net worth standards. Minimum size requirements are not inflexible. If a finance company has reasonable assurance that a firm will grow into a profitable customer, it frequently will extend not only financing, but also managerial advice and assistance. Moreover, size requirements differ as between size of finance company, with the larger specifying higher volume requirements.

SUMMARY

This paper has been concerned with the nature of the industry demands for short-term funds and the various sources from which these demands are met. We have elaborated upon the numerous segments of the market for short-term funds

[39] *Id.* at 454.

to which small business has access. Of even greater importance, we have tried to demonstrate the progressive development and extension of lending institutions and practices which reduce the credit risk posed by the small borrower by utilizing as loan security those assets which small firms have in relative abundance.

Our examination of the availability of short-term funds to small business lends weight to the conclusions[40] of others that the short-term needs of these businesses are being met in a relatively satisfactory way.

[40] See particularly the testimony of A. D. H. Kaplan, A. F. Maxwell, H. L. Thomas, and W. McC. Martin, in *Hearings Before a Subcommittee on Small Business of the Senate Committee on Banking and Currency on the Credit Needs of Small Business*, 85th Cong., 1st Sess. 93, 128-29, 179, 500 (1957).

STATE DEVELOPMENT CORPORATIONS: THE PENNSYLVANIA EXPERIENCE

WILLIAM R. DAVLIN*

Between August 1956 and October 1958, the Commonwealth of Pennsylvania jointly with community nonprofit industrial development corporations, banks, and insurance companies initiated the financing of sixty-eight new manufacturing plants and plant expansions costing $23,700,000 and creating 11,761 new factory jobs, all of them in areas of substantial chronic unemployment. The commonwealth's participation in this financing has been extended through the new Pennsylvania Industrial Development Authority, a public corporation and instrumentality of the state government created by the General Assembly under the Pennsylvania Industrial Development Authority Act.[1]

I

HISTORICAL BACKGROUND

Although Pennsylvania enjoys second position among the states in the nation's manufacturing industry, economic history has dealt her some cruel blows. Since the turn of this century, certain industries upon which she has been dominantly dependent have variously experienced readjustments or maladjustments, economically or technologically. As a result, these industries have failed to generate the volume of employment and business opportunities one normally observes in the American economy. In terms of specific areas and and communities and at differing points in time, this has meant either deterioration of the local economic base or failure of the economic base to expand.

For example, lumbering was a major industry for many Pennsylvania areas and communities in the early decades of the century. The philosophy of exploitation that characterized that industry nationally in those years, lack of reforestation and fire control, and the absence of scientific conservation practices have led to depletion of forest resources and a decline of lumbering in many sections.

Textiles were once a major source of employment in a large number of Pennsylvania communities, large and small. The "flight" of textiles to the South from states of the East following and continuing since World War I, and more latterly the expansion of textiles in the South based on the newer synthetic fibers, has meant, again, a partial deterioration of the economic base in affected Pennsylvania communities.

Anthracite coal has been the major single source of employment in the densely-

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[1] PA. STAT. ANN. tit. 73, §§ 301-14 (1957).

populated, topograpically-rugged counties of northeastern Pennsylvania, with virtually all of the nation's "hard coal" coming from that region. The pronounced shift from coal to oil and gas for space-heating that began in the early 1920's has meant a continual secular decline in anthracite markets and employment since that time.

Much of northwestern and western Pennsylvania has, over the years, sustained itself on the mining of bituminous coal. Bituminous coal markets have experienced a growth in line with national economic growth itself. However, the mechanization of deep mines and the growth of surface ("strip") mining has made possible a vastly greater volume of production per man-day and has resulted in a relative decline in manpower requirements.

Over the years, Pennsylvania has developed the largest railway transportation industry of any of the states, transporting her coal and steel and linking together the East, Midwest, and Southeast. A number of Pennsylvania communities and sections of some of her major cities have been dominantly dependent upon railroad maintenance shops. Dieselization of railroads has cut drastically into this source of employment, and the growth of the trucking industry has meant a sharing between railways and truckers of the increase in freight tonnage.

In 1957, Pennsylvania produced just over one-fourth of the nation's steel; that was an increase of about one-third over Pennsylvania's production during World War II. Yet, United States Census Bureau figures indicate that this Pennsylvania production was achieved with some 33,000 fewer steel workers than during the war, thanks to modernization of steel-making processes.[2]

This concatenation of economic phenomena has given Pennsylvania an extensive problem of chronic labor surpluses that, without burdening the reader with statistical detail, can be characterized as follows:[3]

1. While the Pennsylvania pattern of post-World War II unemployment has followed the national pattern, the unemployment rate in Pennsylvania has tended consistently to exceed the national rate; in recession periods, the Pennsylvania rate has reflected an unemployment situation more severe than nationally.

2. As early as the first quarter of 1958, nationally, seventy major United States Labor Department labor market areas and 121 "smaller" official labor market areas were designated as "Areas of Substantial Labor Surplus" (more than six per cent of the area labor force unemployed). Yet, the ten major Pennsylvania areas made up one-seventh of the national total; the eight of her "smaller" areas in this category made up one-fifteenth of the national total.

3. Nationally, in the first quarter of 1958, nineteen major labor market areas and fifty-seven "smaller" such areas were classified by the United States Department of Labor as areas of *chronic*, substantial labor surplus. At the time, Pennsylvania had five—more than one-fourth—of the major areas of chronic unemployment, and seven —about one-eighth—of the smaller areas in this category.

[2] See U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, U.S. CENSUS OF MANUFACTURES: 1957.

[3] For details see *Hearings Before the House Committee on Banking and Currency on Community Facilities, Area Redevelopment and Small Business Financing Bills*, 85th Cong., 2d Sess. (1958).

These economic vicissitudes provided the stimulus, notably during the years following World War II, for a community industrial development movement in Pennsylvania of considerable magnitude and effectiveness. During those years, some fifty labor-surplus communities, together with their banks, financed 150 manufacturing plants that in prosperous times provide direct employment for 31,000 people; total costs were estimated at $54,500,000. The pattern of financing typically used became known outside Pennsylvania through numerous special magazine articles as the "Scranton Plan," since it was in the Scranton area that the movement had its principal origins and most sizable results. Obviously, however, there were many little Scranton plans.

The approach was for local civic groups to finance the full cost of construction, including land and utilities, of plants occupied under lease-purchase arrangements. The "equity" money was typically raised in civic industrial fund "drives," sometimes on a gift basis, at other times in exchange for debentures or other evidence of indebtedness bearing interest. The major financing was typically in the form of first mortgage loans from local banks. Amortization payments by the tenant companies were used fully to retire all funds injected into the projects, with the civic portion frequently going into a community "revolving fund" for reuse.

The new employment opportunities growing out of this "boot-strap" lifting process, however, were inadequate to compensate fully for the declines in employment in dominant industries, nor to stem the downward trend of total employment in distressed economic areas.

II

The Present Program

The principal element in the present industrial development program was revitalization and professionalization of the state Commerce Department. The Department's personnel was roughly doubled to include some ninety employees, and its industrial development activities were enlarged to embrace research and surveys, technical advisory services and financial assistance to local groups, national advertising, assistance to industrial firms and consulting engineers on plant location surveys, and direct solicitation of out-of-state industry. These services are extended on a state-wide basis, without reference to area unemployment or economic distress. One special tool within the total program, however, is available for use only in areas of chronic labor surplus—Pennsylvania Industrial Development Authority loans.

The Authority's program is a direct outgrowth of the pattern of community industrial financing that has been described. Its principal characteristics were developed in consultation between representatives of the state Commerce Department, on the one hand, and legal and financial specialists from labor-surplus communities that had successfully conducted local industrial financing programs, on the other. It was the view of both groups that the community experience had proven the efficacy of the financing device employed and that any effort on the part of the

state government should be projected within that framework; that it should, in other words, supplement and strengthen the community approach to the problem that had already become traditional in labor-surplus communities.

A principal limiting factor in the pre-existent pattern had come to be the difficulty of the local industrial development organization returning too frequently to the public for equity funds. With conventional first mortgages running between fifty-five and sixty-five per cent of the cost of a given project, the civic organization was left with the necessity of raising thirty-five to forty-five per cent by popular subscription—placing it in competition with the charitable, health, and other "drives" so much a part of community life. Accordingly, it was generally agreed by those in consultation on the matter that the most promising direction for a state effort to take would be to join hands with community groups in sharing the burden of raising the amount required in the pattern for that part of the financing over and above first mortgage funds.

Thus, the central feature of the Pennsylvania Industrial Development Authority program, "the Pennsylvania Plan" or "PIDA," as it is variously referred to, is for the state to provide up to thirty per cent of the cost of new plants or expansions, provided the community group injects at least twenty per cent and arranges for the major financing from private financial institutions. This means, in effect, that the burden of local subscription fund-raising is cut roughly in half, and that funds so raised go twice as far as formerly.

A. The Pennsylvania Industrial Development Authority Act

The Act creating the Authority recites its purpose as being to promote the welfare of the people of the commonwealth by the reduction of unemployment in "critical economic areas" by making loans to industrial development agencies for the payment of part of the cost of building or acquiring industrial and manufacturing plants and facilities for lease or sale. A board of eleven members is created by the Act to govern the affairs of the Authority. Four serve ex officio: the Secretaries of the Departments of Banking, Labor and Industry, Internal Affairs, and Commerce, the latter serving as chairman and chief executive officer. Seven members are appointed by the Governor for staggered seven-year terms, subject to Senate confirmation; these latter represent "the public and the public interest." The state Commerce Department is directed to provide the staff services of the Authority.

Loans of the Authority may be made only in "critical economic areas," and these are defined as encompassing any municipality or group of counties or region of the commonwealth having had not less than six per cent of its labor force unemployed for a period of not less than three years, or nine per cent for not less than eighteen months, immediately prior to the date of the related investigation by the Authority. Loans of the Authority may be made only to nonprofit industrial development agencies having as their primary function the promotion, encouragement, and de-

velopment of industrial and manufacturing enterprises. Under the Pennsylvania Constitution, the commonwealth may not lend money to private business firms.[4]

The twenty per cent of the project cost required to be injected by the local nonprofit group and the thirty per cent loan available from the Authority typically leave half of the project cost to be financed otherwise. The Act requires that the local group must have a firm commitment for this financing before the Authority can act favorably on the loan application. Further, under the Act, the plant can be leased only to a "responsible tenant, or sold only to a responsible buyer," and the local group must have a firm commitment from the prospective tenant or buyer to provide the machinery and equipment and occupy and operate the plant. The Act also requires that loans of the Authority shall bear interest, but empowers the Board to set the rates and fix the terms of its loans.

One normally thinks of these loan transactions as involving a new plant or plant addition, with the Authority taking a second mortgage lien on the new construction as security for its loan. But the Act also gives the Authority a second type of loan power that is peculiarly important and pertinent to the community industrial development situation in Pennsylvania.

It has been previously noted that fifty communities had financed 150 plants, mainly in the years since World War II, prior to establishment of the Pennsylvania Industrial Development Authority. Many of those have since been sold to industrial firms exercising options under lease-purchase agreements. Title to many others, however, is still held by the community groups, and the plants are still in the process of amortization. Of this group, those built during more recent years have substantial balances of principal remaining to be amortized in payments to the community groups (and, of course, also to first mortgage holders). Thus, a community group in many instances will still have funds tied up in a pre-PIDA project in an amount substantially in excess of the twenty per cent required to be injected where PIDA assistance is involved.

In order to release a portion of such previously raised and invested community funds, the Authority is empowered to lend money to the community group, taking as its security a mortgage on the existing plant, provided the proceeds of the loan are used in financing another new project. In these instances, it is required that the community leave at least twenty per cent of the original cost or current appraised value of the plant, whichever is higher, in the project as its continuing investment. This provision has the effect of empowering the Board to assist the community by bringing into the present funds raised by popular subscription in the past and to put such funds to work again in maximizing local industrial employment.

There are two noteworthy provisions of the Act that are in the nature of limitations. First, the Authority may not make a loan where this would cause the removal of a plant from one area of the commonwealth to another. And, secondly, the Authority may not "at any time borrow money or in any manner . . .

[4] Pa. Const. art. 9, § 6.

pledge the credit or taxing power of the Commonwealth or any of its municipalities or political subdivisions, nor shall any of its obligations be deemed to be obligations of the Commonwealth of any of its political subdivisions." Thus, the Authority is very much the creature of the legislature, since the legislature is the sole source of its capital funds.

The 1955 session of the legislature (in May of 1956) appropriated $5,000,000 as the initial capital fund of the Authority. Another $3,000,000 appropriation was made in 1957, for a total of $8,000,000, to date. These monies, under the Act, go into a revolving Industrial Development Fund. Income from interest and loan repayments also go into the Fund and may be used for additional loans.

B. Loan Experience of the Authority

At the outset of this paper, the highlights of loan operations of the Pennsylvania Industrial Development Authority since its inception just over two years ago were listed. Fuller details, as of October 31, 1958, follow:

Total loan commitments (68 projects)	$ 7,917,450
Total cost of projects	$23,742,260
Estimated annual payroll in projects	$37,054,500
Planned employment in projects	11,761

It will have been clear, of course, that these figures do not represent the sum of Pennsylvania's industrial growth during the two-year period. These figures are restricted to industrial development projects located in chronic labor-surplus areas in the financing of which community groups, banks and insurance companies, and the commonwealth, through the Authority, have joined hands. In fact, something like four times this amount of new factory employment has developed by virtue of Pennsylvania's new industrial development program outside PIDA financing, whether directly or indirectly.

1. *Interest rates on Authority loans*

In its early deliberations devoted to the setting of operating policies, the Board apprehended its primary obligation to be so to conduct its affairs as to create the maximum of new employment opportunities. Though directed to charge interest on its loans, it did not interpret that direction to require it to make the maximum possible operating profits through such charges. Recognizing that, in accordance with the Act, its loan operations must avoid even the semblance of a "give-away" approach, it has, nonetheless, conceived its discretion as to interest rates to present an opportunity to offer to interested companies a special inducement to locate or expand plants in chronic labor-surplus areas.

It had been, and continues to be, the practice of the participating local industrial development groups to charge an interest item into its transactions on its own portion of the project financing. This has been an obvious necessity when local subscription funds have been raised by evidences of indebtedness bearing interest. This

practice has been followed, also, where local funds were raised wholly by gift, or through a combination of debt to the citizens and gift. In these latter instances, the local group has, however, enjoyed a latitude under which it could fix its rates lower than might otherwise be the case.

In light of the foregoing, the Authority has established a policy creating a minimum two per cent interest rate on its loans, which it varies in accordance with the community group's interest rate when the latter is between two and three per cent. Where the community is charging in excess of three per cent, the Authority arrives at its own rate after examining the local circumstances involved, always with a view to keeping its own interest rate consistent with the purpose of creating an inducement. The objective of the policy is to persuade the community group to make its interest rate as low as practicable. Low interest rates on half of the project cost (the community's twenty per cent share and the Authority's thirty per cent) mean a significant saving in interest expense to the tenant-buyer, and a meaningful inducement.

Interest rates on the first mortgage financing from banks and insurance companies remain, of course, at the going commercial rates.

2. *Repayment of Authority loans*

Having been left free also to set the term of its loans, the Authority has, on the basis of community experience in Pennsylvania with this type of financing, set a maximum term of twenty-five years. In practice, however, the maximum term has seldom been used; most of the Authority's loans are set up for repayment within a period of twenty years and less.

Again, however, by way of enhancing the attractiveness to companies of its financing plan, the Authority early determined that it would, where requested and where other factors seemed to warrant it, defer repayment of its loans until after retirement of the first mortgage in the given case. This practice has the obvious effect of reducing annual amortization charges being paid by companies occupying the plants financed under the plan; while no ultimate saving of principal is involved to the companies, they, nonetheless, have the benefit of reduced expenses in new facilities during the early years of operation, when needs for operating economies and working capital may be primary considerations.

In instances where deferment of repayment of its second mortgage loans has been requested and granted until retirement of the first mortgage, the Authority has stipulated in its loan agreements, again as a matter of established policy, that the interest rate on its second mortgage rises to that of the first mortgage upon retirement of the latter. Since at that point an Authority's loan is in a first mortgage position, enjoying a 100 per cent lien on a project in which it has invested only thirty per cent of the cost, such mortgage paper would be attractive to outside investors, provided the interest rate thereon were commensurate with "going" commercial rates. For these reasons, the Authority has anticipated that the Board of Directors

would then sell its mortgage paper of this type and secure a quick return of its outstanding money into its revolving Industrial Fund.

3. *Plant expansions, branch plants, relocations*

The nature of traditional community industrial financing in Pennsylvania, coupled with the characteristics of the Authority's loan powers, has enabled it to serve both the out-of-state firm and the established Pennsylvania manufacturer.

Of the sixty-eight Authority loan commitments through October 31, 1958, nineteen have been for the expansion of plants already located and operating in Pennsylvania; five have been for new branch plants of Pennsylvania manufacturers. Of the remaining loan commitments, three are for new plants being built in part with funds borrowed by community groups using previously-financed buildings as security; they are being built in advance of and in order to attract commitments from a manufacturing firm to locate. The twenty-five remaining loans are for projects which involve the relocation of plants from other states; and sixteen are for branch plants of companies from other states. The places of origin of these relocations and branch plants will be of interest. They are as follows:

Relocation of Plants From Other States (25)
From:
New York, N.Y.—8
Brooklyn, N.Y.—6
Baltimore, Md.
Waterbury, Conn.
Middletown, N.Y.
Youngstown, Ohio
Newark, N.J.
Montclair, N.J.
Belleville, N.J.
Wellsburg, W. Va.
Hoboken, N.J.
Long Island, N.Y.
Parkersburg, W. Va.

Branch Plants of Companies From Other States (16)
From:
New York, N.Y.—4
Long Island, N.Y.—3
Chicago, Ill.—2
Detroit, Mich.—2
Jamestown, N.Y.
Omaha, Neb.
Miami, Fla.
Edgerton, Wis.
South Bend, Ind.

4. *Characteristics of projects financed*

American manufacturing industry is essentially "small business," in the sense that out of the numerical total, the giant steel, chemical, automotive, and heavy industrial equipment firms, for example, are a small minority. The *model* manufacturing firm is a fabricator or component producer, of one type or other. Thus, in the listing of firms occupying plants financed under the PIDA program, few are nationally-known. Some are, however. The Eberhard Faber Pencil Company, relocated in Wilkes-Barre, Pennsylvania, from Brooklyn in a plant financed in part with PIDA funds, is a

major national producer in its field. Chrysler occupies a plant for the production of ordnance tank parts at Scranton, similarly financed. Mergenthaler ("Linotype") is to occupy another at Wellsboro; Tetley Tea, still another at Williamsport.

The sixty-eight projects have ranged in size from a building of 8,000 square feet to one of 260,000 square feet; in cost from $16,800 to $2,400,000. PIDA loans have ranged from $10,500 to $720,000. Plant employment in the projects has ranged from twenty-five workers to 600. Product-wise, the plants include food, postal-canceling machinery, tubular copper products, steel scaffolding, scientific instruments, aluminum building materials, aircraft engine components, commercial chemicals, and garments, in addition to the products noted in the instance of the nationally-known firms listed above.

Conclusion

The Pennsylvania Industrial Development program of industrial financing grew directly out of Pennsylvania industrial development experience at the local level. It works effectively in Pennsylvania mainly because it is essentially only an extension of an approach to financing tested and tried at the community level over a period of many years, prior to participation by the commonwealth.

The use of public funds for financing of private industrial activity, at least non-federal governmental funds, has been and perhaps will for the foreseeable future be questioned on philosophic grounds. It has not been seriously questioned on those grounds in Pennsylvania, and the program has the full support of the business community of the state; banks and insurance companies have entered fully into it with their first mortgage funds.

That this acceptance has been so readily forthcoming is doubtless attributable to the critical need for Pennsylvania to achieve economic redevelopment in its distressed areas. So long as those areas suffer economic decline, they constitute a serious drain on the financial resources of state and local government (through expenditures for unemployment compensation and public assistance, among other things) and a serious wastage of manpower. Pennsylvanians have considered that redevelopment purpose as a valid object for the expenditure of public funds in industrial financing.

From the standpoint of small business, the availability of financing through state and local development corporations can be an important consideration in determining what projects can be undertaken and whether expansion is possible. Indeed, the increasing use of such corporations may be an important factor in the ability of small business to maintain an important position in the national economy.

THE IMPACT OF TAXATION ON SMALL BUSINESS

E. Gordon Keith*

The impact of the federal tax system on small business has been a matter of increasing interest and concern to many persons during the last few years. When the heavy spending during World War II forced Congress to increase very sharply federal taxes on both individual and corporate income, it was confidently expected that the high wartime rates would be reduced to more reasonable levels once hostilities had ended. Unfortunately, these expectations have been realized only to a very limited extent.

Although we were finally able to let the wartime tax on excess profits expire in 1954, we have not been able to go very far in reducing personal or corporate income taxes. In fact, the present fifty-two per cent rate on corporate profits in excess of $25,000 is a good deal higher than the forty per cent rate on ordinary profits that was in effect during World War II. Rates on personal income have been reduced slightly since the war; but most of the relief which individual taxpayers have received since then has taken other forms. Higher exemptions and new deductions and exclusions have reduced the percentage of personal income subject to taxation; and the option given to married couples to file joint returns so as to enjoy the advantages of "income-splitting" gave substantial tax relief to many of these taxpayers. In the field of business taxation, relief has taken the form of more liberal depreciation and depletion allowances, greater opportunities to give expense treatment to research and development outlays, and longer periods for averaging out profits and losses. Many of the changes made in federal business taxation between 1946 and 1954 were helpful to small business; but they still left small enterprises, as well as large ones, with tax burdens that were enormously greater than those which they had experienced before the war.

While this burden of federal taxation was known to be a repressant to all business, its impact was thought to have been especially severe on small businesses, mainly because they had little or no access to public markets for capital. Furthermore, despite the efforts that had been made to aid small business in the 1954 revenue revisions, it was argued that the law still contained provisions which unintentionally discriminated against small concerns. Attention was also called to some evidence that high federal taxes were discouraging the formation of new small enterprises and were impeding the growth of old ones.

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Those who believed that further steps should be taken to strengthen the small business sector of the economy received some support from the President's Cabinet Committee on Small Business, when it made its first progress report on August 7, 1956.[1] This Committee, which had been appointed by the President at the end of May, and was headed by Dr. Arthur F. Burns, who was also the Chairman of the Council of Economic Advisers, agreed that small business had been hurt more by high taxes than had the larger firm and recommended several changes in the Revenue Code which it thought would be helpful.[2] Still further support for tax relief for small business was offered by the Senate Small Business Committee after several months of hearings held in fourteen cities in different parts of the country during the fall of 1957.[3] Most of the 293 witnesses who testified before the Committee were small businessmen with specific complaints to make regarding the incidence and effects of federal taxes. In the report which this Committee drafted early in 1958 for submission to the Senate, a number of ways were found in which it was thought that the Revenue Code, and those who were responsible for its administration, were unfairly burdening small business. The report also made a number of recommendations for removing this discrimination.[4]

On the other hand, the position of small business in the American economy was appraised somewhat more optimistically in a number of studies contained in a report prepared by the Federal Reserve System, which was published in April 1958.[5] Although these studies are not directly concerned with the impact of taxation on small business, they do suggest that in some respects the so-called plight of small business may be less serious than it has usually been pictured by small businessmen.

The tax problems of small business have, then, been very much in the public eye during the past few years. There has been much discussion of the needs of small concerns for tax relief, and careful consideration has been given to the various ways in which this might be given. Although the Government's budgetary situation during this period has not permitted the granting of any very substantial tax reductions either to big or to small business concerns, the changes in the tax law that were made in 1954, as well as those effected by the Small Business Tax Revision Act of 1958,[6] were intended to be especially helpful to such firms. Yet, with all this discussion, and despite the apparent conviction with which Congress has moved to amend the Revenue Code in small business's behalf, the picture we get of the impact of federal taxes on small business is still not very clear. This is probably attributable in part to the fact that the small business sector of the economy is itself not very clearly defined, and to the fact that it embraces a great many different types of

[1] CABINET COMMITTEE ON SMALL BUSINESS, PROGRESS REPORT (1956).

[2] *Id.* at 2-4.

[3] Select Committee on Small Business of the Senate, *Tax Problems of Small Business*, S. REP. No. 1237, 85th Cong., 2d Sess. (1958).

[4] *Id.* at 8-24.

[5] FEDERAL RESERVE SYSTEM, 85th CONG., 2d SESS., REPORT ON FINANCING SMALL BUSINESS pts. 1 and 2 (Comm. Print. 1958) [hereinafter cited as FEDERAL RESERVE REPORT].

[6] 72 STAT. 1606 (codified in scattered sections of 26 U.S.C.).

enterprises upon which high taxes may have different impacts. As was pointed out in one of the Federal Reserve System studies, most small businesses are quite routine operations carried on within protected local markets; but some are pioneering ventures which, through the promotion of new products or the development of new processes, seek to enlarge their markets and to challenge the position of established firms.[7] Furthermore, in many cases, the effects of taxation are qualitative rather than quantitative in character, which makes them more difficult to measure. Finally, it is sometimes difficult to isolate the impact of tax changes from the impact of other developments on small business; taxes are often blamed for events mainly attributable to other factors.

Although it is always difficult to solve a problem which has as many facets as this one appears to have, it should at least be possible to bring the main issues into somewhat clearer focus. From the standpoint of policy, the questions which we should like to be able to answer are reasonably clear. First, do high taxes bear more heavily on small concerns than they do on larger ones, even when they are imposed uniformly? And second, are there provisions in the present federal tax structure that intentionally or unintentionally discrimate against small business? Only if one or both of these questions can be answered in the affirmative would it seem possible to regard the tax problem of small business as being separate and distinct from that of business generally. These, then, are the questions on which we shall focus most of our attention in the balance of this paper. But before turning to them, a bit more will be said about small business itself and the role which it plays in the present-day economy.

I

SMALL BUSINESS AND ITS ROLE IN THE ECONOMY

We are told that there is no generally accepted definition of a "small" business, and that most persons who use the term do so without having in mind any specific definition of size.[8] One can, of course, classify business firms by such quantitative criteria as the number of employees, total assets, or total sales, and then designate certain size classes as representing small business. For example, for purposes of financial aid from the Small Business Administration, a manufacturing firm is designated as "small" if it has fewer than 250 employees, while in the Federal Reserve business loan surveys, total assets have been used as the criterion for classifying borrowers as "small." Yet, these designations are at best arbitrary, and they usually cannot be applied uniformly to firms in all industry groups. Qualitative criteria can also be used in attempting to define and identify a small business. It has been said, for example, that a small business is "one that is too small to float securities on the public market," or "one that sells its goods and services in one community or

[7] Garvey, *Observations Based on the Background Studies*, in FEDERAL RESERVE REPORT 1, 7-9.

[8] For a discussion of alternative methods of defining small business, see Stockwell, *What Is a "Small" Business?*, in FEDERAL RESERVE REPORT 150.

to one customer," or is simply "one with a problem." Definitions such as these suggest that what is a "small" business depends to a considerable extent upon the type of analysis for which the definition is needed.

For the purpose of analyzing the impact of taxation on small business, qualitative criteria would appear to be more appropriate than quantitative ones. Tax disadvantages arise not because a concern has less than 100 employees or less than $250,000 in assets, but because it is dependent upon internal sources of funds to finance its growth, or because it is unable to exercise effective control over its prices and profits, or for some other reason of a similar nature. Qualitative criteria such as these cannot, of course, be applied very exactly, and they give us only a rough notion about the size of the universe with which we are concerned. On the other hand, it is possible that they can be equated fairly well with the more conventional definitions. Certainly, most of the concerns which would be classified as small by the Small Business Administration and by the Federal Reserve System for their respective purposes would also share such qualitative criteria of smallness as were mentioned above. This means that our universe comprises at least ninety-nine per cent of the firms operating in all industries, and at least ninety-three per cent of the firms engaged in manufacturing.[9]

But certainly not all of the 4,000,000 concerns with less than 100 employees are subject to tax disadvantages that are unlike those experienced by taxpayers generally. If our present tax structure does discriminate against small business, this discrimination would appear to be felt mainly by the minority of nonroutine businesses which have growth potential, and which have something to offer the larger firms that might like to absorb them through purchase or merger. Moreover, the generally accepted proposition that the existence of small business in this country is of vital importance because it makes the economy more efficient and progressive is one which can be strongly defended only if it applies to firms of a more dynamic character. These firms do play a vital role in the maintenance of active competition, and if high taxes or discriminatory provisions in the Revenue Code are weakening this type of competion, we shall be the losers. Hence, there is some reason to be concerned about the impact of taxation on small businesses of this type.

Some persons would go even further and argue that the importance of these pioneering firms is so great that the tax laws ought to discriminate positively in their favor. This, it is held, would compensate for certain nontax handicaps of small business. This proposal has, however, never been taken very seriously by those who shape the nation's tax policies. There has been no desire, either to subsidize inefficiency, or to penalize large concerns "that have come to the top through honest competition."[10] Nor do many small businessmen desire special tax favors. Given a "fair break," they believe that they can hold their own against their larger

[9] Of the 4,067,300 firms in operation on January 1, 1951, 4,030,400 had fewer than 100 employees. Of the 322,900 manufacturing concerns in operation on that date, 302,800 employed fewer than 100 employees. Survey of Current Business, May 1954, p. 23.

[10] CABINET COMMITTEE ON SMALL BUSINESS, *op. cit. supra* note 1, at 4.

competitors. The question is, of course, whether they are getting a "fair break" under our present tax structure. Many of them clearly do not think so.

II

THE IMPACT OF HIGH TAXES ON SMALL BUSINESS

High federal taxes can affect the size and strength of the small business population in several ways. They can reduce the number of business births by discouraging those who might otherwise form new businesses. Second, they can slow down the rate at which small businesses are able to grow by making it more difficult for them to finance a rapid expansion. And third, they can weaken the desire and the ability of small concerns to survive as independent enterprises by making the gains from a sale or merger look more attractive than the income to be derived from continued operation. It can be argued from the experience of individual firms that high taxes have done all three of these things, but there are no data that indicate the extent of the impact in any of these directions.

A. Taxes and Business Births

During the years which have elapsed since the end of World War II, the number of new businesses formed has exceeded 300,000 every year. The peak years occurred right after the war when a great many men were coming out of the service; but, after setting a slower pace in 1948 and 1949, new business formations have held steady since that time.[11] But the fact that the number of new business firms formed has remained high during the postwar years does not necessarily mean that high taxes have not been a deterrent to the establishment of new enterprises. To the extent that high personal income levies reduce the disposable income of persons in the middle and upper-income classes, they also tend to reduce the supply of equity funds available to finance new concerns; and, to the extent that they reduce the prospective returns from the purchase of shares in new firms, they tend to reduce the attractiveness of such shares for prospective investors. Investors in new small businesses ordinarily have to assume greater risks than do those who invest in the stocks of established firms; and these greater risks will not be assumed unless the expected returns are also proportionately greater. The higher taxes are on business income, the harder it is for new enterprises to meet this test. Furthermore, the small businesses to which outside investors are most likely to be attracted are those which are expected to grow rapidly; yet, it is known that high taxes can create serious financial problems for any rapidly growing business. High taxes are also likely to prove embarrassing to firms which have a weak control over their prices and profits. Since small firms usually have less effective control over their prices than large

[11] Markham, *Trends in the Relative Importance of Small Business* in FEDERAL RESERVE REPORT 197, 212.

ones do, they are less able to shift their taxes forward onto consumers, and this also tends to weaken their position in the equity capital market.[12]

On the other hand, one should not exaggerate the adverse effects of high personal and corporate income taxes on the availability of equity capital for new enterprises. That small business has been able to attract large amounts of capital funds during the postwar years is shown by the number of new firms started during this period. One writer has estimated that between 1946 and 1956, over $10,000,000,000 was invested in new businesses, of which $6,000,000,000 was equity money.[13] Almost all of this huge flow of investment funds is thought to have gone through informal channels. The view has also been expressed by at least one investment banker that high personal income taxes have not necessarily made it more difficult for new small businesses to raise outside equity capital.[14] There has, it is said, been an increase in the number of persons of moderate means who have become interested in capital gains. Such persons are frequently attracted by the growth possibilities offered by new firms. Indeed, if there is one proposition on which virtually all students of small business finance are agreed, it is that the problem of raising equity capital for small concerns would be much more difficult if the preferential tax treatment currently accorded capital gains were to be abolished.[15]

Although the capital gains prospect induces a good many investors to risk their savings in the shares of new business ventures, the fact that losses of small business stock could not, until this year, be used except to offset capital gains was a deterring consideration.[16] Persons with diversified portfolios on which they were regularly realizing capital gains were not bothered by their inability to use these losses as an offset to their other income; but this limitation on loss offsets undoubtedly kept some persons from buying small business stocks.[17] The owners of closely-held enterprises could, of course, have made certain of their tax offsets for losses by using the partnership rather than the corporate form of organization, although they might have hesitated to expose themselves in this way to an increase in their contingent liabilities. As we shall note in a later section of this paper, the recently enacted Small Business Tax Revision Act of 1958 has gone a long way towards removing this deterrent to investment in small business corporations.[18]

[12] *Id.* at 542. This point was also made in the 1957 hearings of the Small Business Committee of the Senate. See *Hearings Before the Senate Select Committee on Small Business on the Impact of Federal Taxation on Small Business*, 85th Cong., 1st Sess. pt. 1, at 253 (1957) [hereinafter cited as *Hearings*].

[13] Schweiger, *Adequacy of Small Business Financing: Another View*, in FEDERAL RESERVE REPORT 124, 130.

[14] *Id.* at 145.

[15] *Id.* at 543.

[16] *Id.* at 544.

[17] Individual taxpayers may use a net capital loss as an offset against ordinary income only up to the amount of $1,000, except as noted below.

[18] Under the Small Business Tax Revision Act of 1958, 72 STAT. 1606 (codified in scattered sections of 26 U.S.C.), certain holders of small business stock are permitted to treat a loss from the sale of such stock as an ordinary loss.

B. Taxes and Business Growth

The Senate Small Business Committee was told repeatedly by the small businessmen who appeared before it in the fall of 1957 that the basic problem facing small business today is that of acquiring equity capital for necessary growth and expansion.[19] Many witnesses complained about their inability to obtain the necessary funds for plant expansion or for additions to inventory. As one witness put it, "We have not been able to retain enough earnings in the business to hold our place in the industry, in the economy and among our competitors."[20] Another stated: "Our greatest problem at this time is our inability to purchase the new machines required in our industry under current demands from the profits remaining after taxes. If we are to stay in business, these new machines are a must in order to meet rigid inspection of new products."[21]

In addition to making it more difficult for small businesses to finance necessary growth, high taxes on business income are said to destroy the incentive for growth and efficiency. One businessman told the members of the Senate Committee: "Too many times a contemplated expansion program is dropped because it is just not worth the risk for possible after-tax gain."[22] These statements are, of course, expressions of individual opinions, and the problems they depict are certainly not unique to small business. Nevertheless, the Senate Committee concluded, as did the President's Cabinet Committee on Small Business, that the high postwar taxes had been especially severe in the case of small concerns, largely because of their greater dependence on retained earnings.[23]

Not all of the witnesses who appeared before the Senate Committee shared this concern over the effects of high taxes on the growth of small concerns. For example, Dean Lawrence C. Lockley, of the University of Southern California, argued that "the small business firm is under no disadvantage which requires preferential tax treatment from the standpoint of credit facilities." Legislation which gave small firms unusual tax advantages would, he thought, lead to a waste of public and private funds under normal conditions. It was his opinion that small business can expand and stand "on its own two feet without any help from the Government."[24]

Several contributors to the Federal Reserve System's study of small business financing considered the adequacy of the supply of equity and loan funds for small enterprises. After examining the earnings records of small business firms since the war, and the savings practices of small businessmen, Irving Schweiger, of the University of Chicago, concluded that these data at least suggested that "a large percentage of small businessmen have all the equity funds they require plus considerable resources outside the business which can be tapped if desired."[25] While most of the earnings data relating to small business suffer from distortion due to the tendency of

[19] Select Committee on Small Business of the Senate, *supra* note 3, at 3.
[20] *Id.* at 4. [21] *Ibid.* [22] *Hearings* 85.
[23] CABINET COMMITTEE ON SMALL BUSINESS, *op. cit. supra* note 1, at 2.
[24] *Hearings* 141.
[25] Schweiger, *supra* note 13, at 130.

small firms to understate income and overstate deductions, earnings before allowance for officers' compensation appear to have been quite high in relation to net worth. Statistical data bearing on this point are not abundant; but Schweiger did find evidence that small manufacturing had a high rate of earnings after taxes in the postwar period, and, in relation to net worth, one that was possibly higher than that of large manufacturing concerns.[26] On the other hand, an examination of studies that have been made of family savings and net worth suggested to him that there is a real difference between the saving behavior of business and non-business groups, and that many businessmen have been able to save larger amounts than are needed to finance the expansion of their own firms.[27]

As regards loan funds, there are no data showing the change in debt of all small businesses since the war, but the Securities and Exchange Commission and the Department of Commerce have jointly prepared estimates of the change in debt of nonfarm unincorporated businesses to banks and insurance companies, and to all other corporations. These estimates, which show a $34,000,000,000 increase in the outstanding debt of unincorporated firms to corporations, between 1946 and 1956, are viewed as not supporting the widely accepted view that the sources of credit for small business are becoming more limited.[28] Schweiger also cites the 1955 Commerce Department survey of the external financing of small and medium-sized businesses, which found that fifty-six per cent of all firms had no desire for outside funds, and that approximately half of these desiring such funds attained the full amount desired.[29]

Although he was unable to find much published data bearing on the point, Schweiger thought there were grounds for believing that small, rapidly expanding firms which are most in need of external equity funds were best able to attract them, both because the marginal rate of return on added equity investment of growth companies is high enough to enable them to pay an attractive price for such funds, and also because of the attractive opportunities they offer for capital gains. On the other hand, it was his opinion that closely-held firms which have exhausted their informal sources of funds, and which do not represent attractive "growth" situations, might have considerably more difficulty in expanding their equity capital.[30]

A. D. H. Kaplan and Paul Banner, who also prepared a report on the adequacy of small-business financing for the Federal Reserve System's study, agreed that financing facilities for small business for short-term borrowing are reasonably adequate; but they found them becoming less so as the term for which the financing is desired lengthens.[31] They also noted that the new invention or "exciting innovation" appears to stand a better chance of attracting outside funds than the profit possibilities opened up by less spectacular changes, even when the latter could add up to considerable growth for an established small enterprise. Small firms may, it seems,

[26] *Id.* at 127. [27] *Ibid.* [28] *Id.* at 139.
[29] *Id.* at 149. [30] *Ibid.*
[31] Kaplan & Banner, *Adequacy of Small Business Financing*, in FEDERAL RESERVE REPORT 107, 122.

reach points in their growth cycles where significant cost reductions can be achieved through specialized equipment and larger volume; and at such points, they are confronted with the choice of expanding, or of resigning themselves to remaining high-cost and low-volume producers.[32] During these critical periods, when the small businessman must balance rapid growth and financial weakness against slower growth and possible loss of market, high taxes undoubtedly make it more difficult for him to elect to expand.

While it would appear to be well-established that high personal and corporate incomes taxes have made it more difficult for dynamic small businesses to finance their growth, the impact of taxation has clearly been more severe on some of these firms than on others. The small firm with bright prospects for very rapid growth has to go outside for new equity funds anyway; and a tax structure that stimulates inherently venturesome individuals to seek out growth situations of this kind may actually make it less difficult for firms of this type to secure the funds they need. But the rate of growth needed to make a small business an attractive investment is apparently quite high,[33] and those small firms that cannot meet this test are forced to depend almost exclusively on retained earnings for additions to their equity capital. These latter firms are undoubtedly the ones which complain most about the burden of taxes on small business, although lower taxes would not appear to provide the complete answer to their financial problem. Even if they were permitted to retain a much higher percentage of their profits, many of the dynamic small businesses in this country would still need to attract some external capital. But to do this, as we have seen, they must be able to hold forth the promise of unusually rapid growth. To the extent, therefore, that the growth of small business is being retarded by an inadequate supply of equity funds, only a part of the blame for this can be laid to high taxes.

C. High Taxes and Small Business Survival

Although some 300,000 new businesses are started in this country each year, almost as large a number are discontinued. The bulk of the firms in both categories are, of course, small enterprises. Since 1948, the annual net increase in the number of businesses in operation has averaged about 41,000 firms, with both the number of business births and the number of business deaths rising moderately.[34]

Businesses may be discontinued for a number of reasons. Some discontinuances are forced by failure, although the number of failures appears to account for only a small fraction of all business deaths over the years.[35] In other cases, firms may

[32] *Id.* at 121.

[33] Those interviewed in connection with the Federal Reserve System's survey of opinion among persons involved in supplying external equity capital to small business were generally of the opinion that the prospect of a 20% annual appreciation on their investment was needed to induce investors to put equity funds into small enterprises. Brown, Miller, Ritter, & Robinson, *Availability and Cost of External Equity Capital for Small Business Ventures*, in *id.* 525, 536.

[34] Markham, *supra* note 11, at 211.

[35] *Id.* at 213; Kaplan & Banner, *supra* note 31, at 117.

voluntarily wind up their affairs without involving creditors in losses; and in still others the discontinuance may be the result of an absorption or merger.

High taxes do not appear to contribute significantly to small business failures, the blame for which has usually been placed on such personal factors as incompetence, inexperience, lack of judgment, and the like. On the other hand, some writers argue that a basic reason for the high turnover in the new business population is undercapitalization.[36] Since the new business that fails within a year or two after its formation rarely has earned any profit or incurred any tax liability, high taxes cannot be directly blamed for its inability to accumulate capital out of earnings; but the impact of high taxes on the personal savings of the owners of the new business could, of course, have contributed to the original undercapitalization of the firm.

The present federal tax structure is, however, known to have had a very considerable influence on the extent and character of the merger activity that has taken place in this country since 1940. In an intensive study that was made at the Harvard Business School a few years ago of the effects of taxes on mergers, it was found that certain features of the tax structure were exerting strong pressures on the owners of closely-held bsuinesses to sell out or to merge with other companies.[37] Decisions to sell closely-held businesses were found to be prompted mainly by the anticipation of liquidity problems under the estate tax in the event of the owner's death, and to be reinforced by the desire of the owners of successful firms to take out their profits without having them taxed at ordinary income tax rates.

At that time, it appeared that liquidity problems were likely to arise under the estate tax whenever a substantial block of the stock of a closely-held company was owned by a wealthy individual and constituted a major fraction of his investment portfolio.[38] If, at the same time, there was no market, or only a very thin market, for such stock, estate tax liabilities could force its sale under unfavorable conditions, to the detriment of the business itself as well as to the heirs of the former owner. In addition to these liquidity considerations, there was considerable uncertainty as to the value which the Treasury would place on the shares of such companies for estate tax purposes. The desire to avoid this uncertainty was believed to have had some influence on decisions to sell out, although probably not a very great one in most cases.

It was also apparent that the large differential which wealthy individuals find between high personal income taxes and the much lower levies on capital gains has reinforced the impact of the estate tax on the owners of profitable closely-held busi-

[36] Kaplan & Banner, *supra* note 31, at 117.

[37] J. KEITH BUTTERS, JOHN LINTNER, & WILLIAM L. CARY, EFFECTS OF TAXATION, CORPORATE MERGERS (1951).

[38] Some relief from these problems was afforded by certain provisions of the Small Business Tax Revision Act of 1958, 72 STAT. 1606 (codified in scattered sections of 26 U.S.C.).

nesses.[39] While such persons have been understandably reluctant to withdraw accumulated earnings in the form of cash dividends that, since 1954, have been taxable at rates as high as ninety-one per cent, they have clearly been attracted by the opportunity afforded them under the present tax law to take their profits out in the form of capital gains from the sale of the business, which are taxable at a maximum rate of twenty-five per cent.

Even when the age of the owner of a small closely-held business has been so low that he has had little reason to be concerned over the imminence of heavy estate taxes, the income tax structure by itself appears to have encouraged the sale of small growing businesses in which the owners have built up substantial equities which might be lost if future competition became more keen, or if general business conditions worsened.[40] In such cases, the knowledge that gains realized from the sale of the business will be taxed at the low capital gains rate has frequently influenced the owner's decision to cash in on his profits at once by selling his business to another company, rather than continue to operate it himself as a separate business entity.

Still another situation where the federal tax structure has been found to encourage the discontinuance of small businesses through a sale or merger is the one in which a successful closely-held firm has earnings substantially greater than its needs for additional capital. In such cases, further accumulations of earnings might risk the imposition of the old section 102 penalty tax on corporations improperly accumulating surplus. On the other hand, the owners of these concerns may not wish to receive larger dividends on which they would have to pay very heavy personal income taxes. In situations of this kind, the outright sale of the business has been an attractive way of avoiding both of these undesirable tax consequences. Alternatively, mergers have been effected with larger companies much less likely to be subject to the penalty tax on unreasonable retentions.

Views similar to those encountered by the men who made the Harvard Business School survey were expressed at the hearings of the Senate Small Business Committee, in 1957. One California businessman told the committee that the only way in which small business owners can fully reap the benefits of their efforts over past years in building a business is by selling it and taking the money received at the capital gains rate.[41] He said that one man had told him "that at the present rate at which he was adding surplus to his small company's account, it would take him ten years to obtain the amount that he could obtain by selling out now at capital-gain rates." Other witnesses testified to the effects of the estate tax in fostering economic concentration.[42]

[39] Lintner, *Tax Considerations Involved in Corporate Merger,* in SUBCOMMITTEE ON TAX POLICY OF THE JOINT COMMITTEE ON THE ECONOMIC REPORT, 84th CONG., 1st SESS., FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 690, 695 (Comm. Print 1956).

[40] *Id.* at 696.

[41] *Hearings* 160.

[42] Select Committee on Small Business of the Senate, *supra* note 3, at 12.

Thus, it would appear to be well established that high federal taxes on income and estates have made it difficult to maintain the continuity of many small closely-held businesses in recent years. When the owner-manager of such a firm wishes to retire, he can usually minimize his tax liabilities and increase the liquidity of his estate by selling out to, or exchanging shares with, another larger corporation. If, on the other hand, he were to transfer ownership to persons who would continue to operate the business as an independent enterprise, he would ordinarily have to assume greater risks and incur heavier tax liabilities. And when the owner-manager of a closely-held small business dies before divesting himself of his interests in it, the pressing need for cash to pay his estate taxes has, again, given large corporations an advantage over other prospective purchasers. As will be noted later in this discussion, post-1950 amendments of the Internal Revenue Code have softened the impact of the estate tax on small businesses to some extent. But while these changes have made it easier for family corporations to maintain an independent existence following the death of a major owner, they have done little to promote the continuity of small enterprises as independent units in those situations where the owners may desire to relinquish ownership before death.

III

THE IMPACT OF SPECIFIC TAX PROVISIONS AND PRACTICES ON SMALL BUSINESS

The tax complaints of small businessmen have not been directed exclusively at the magnitude of their over-all tax burdens and the effects which they believe these burdens are having on the ability of small concerns to grow and to survive. Small businessmen have also complained that certain provisions of the Revenue Code, and certain practices of the Revenue Service, discriminate against small firms. And they have argued that the increasing complexity of the Revenue Code, as well as the uncertainties that surround its administration, impose extra and discriminatory burdens on these firms. Complaints such as these deserve careful consideration. For although many persons will not agree that our tax laws should discriminate in favor of small business, few if any would contend that the laws should discriminate against the small firm. What, then, are the areas in which discrimination against small business is said to occur?

One section of the Code which is said to bear especially heavily on small business is section 531 (formerly section 102) which imposes a penalty tax on unreasonable accumulations of surplus. Although, since 1954, the burden of proof as to the reasonableness of surplus accumulations has fallen on the Government rather than the taxpayer, and although it is generally recognized that the effect of the provision today is almost wholly psychological, its presence on the statute books still is said to be an additional burden on small concerns that is not thrust on larger publicly-owned corporations.

If there is any merit in this complaint, it would appear to lie in the fact that small business firms are subject to a tax uncertainty that larger concerns can safely dis-

regard. The object of the accumulated earnings tax is, of course, to discourage the owners of certain closely-held companies from doing something that the owners of large public companies cannot possibly do—namely, controlling the flow of corporate dividends with a view to avoiding personal income taxes. Few corporations have ever been made to pay this peanlty tax, and the question of possible liability under it has been raised by the Revenue Service only in a relatively small number of cases. Nevertheless, this is clearly a provision which must be retained in the Revenue Code in the interests of over-all tax equity, even though it does affect only small closely-held companies, most of which have wholly legitimate reasons for retaining income. The most that can be done to ease the psychological impact of this levy on innocent firms is, perhaps, to increase, as Congress recently did, the amount of the minimum accumulated earnings credit.[43]

A second and more important area of possible discrimination against small business has been found in the provisions relating to depreciation allowances. Prior to 1954, the complaints of small businessmen were directed mainly at the manner in which the depreciation provisions of the Revenue Code were administered; but since that time, they have had a complaint against the statutes as well. Up until 1954, businesses were permitted to write off the cost of capital improvements in accordance with rules laid down by the Internal Revenue Service in Bulletin F, which, among other things, indicated the length of time over which assets of various types should be written off under normal conditions. Any taxpayer wishing to spread his depreciation allowances over a shorter period had to assume the burden of proof; and it is not unlikely that large firms were more successful in securing exceptions than were small ones. In any case, small businessmen have long been critical of the administrative rulings which prevented them from accumulating, in the form of depreciation reserves, as much working capital as they thought they were entitled to.

The Internal Revenue Code of 1954 did not change basically the method of determining the normal useful lives of depreciable assets, but it did give taxpayers the option of using a liberal declining-balance formula in place of the traditional straight-line one in determining the amount of depreciation that could be taken in any one year. Under the new formula, it was possible to write off roughly two-thirds of the cost of an asset over the first half of its useful life, whereas under the old one, the same amount was written off each year. With depreciation charges thus accelerated, and income taxes correspondingly reduced, the new formula was especially helpful to growing firms that were continuously adding to their stock of depreciable assets. The 1954 law, however, allowed the declining-balance formula to be used only in the case of new assets. This meant that those firms which bought used machines or second-hand equipment could not enjoy the benefits of accelerated depreciation. And since the firms which buy used rather than new capital assets are

[43] See p. 115 *infra*.

typically small firms, this limitation was held to be a new form of discrimination against small business.[44]

There would appear to be some merit in this complaint, although the arguments in support of the limitation are stronger than most persons have realized. From the standpoint of the theory of the depreciation allowance, it can be argued that the value-erosion pattern that is implicit in the declining-balance formula is not as appropriate for used assets as it is for new ones. Records show that the resale prices of new machines fall quite sharply during the early years of their use, and decline more gradually thereafter. But this is not believed to be the case with used machines. Accordingly, to allow accelerated depreciation with respect to second-hand equipment would be to allow the owners of these assets to understate their income for tax purposes, and so enjoy a tax subsidy to which they were not entitled. Furthermore, from an administrative standpoint, allowance of accelerated depreciation on used assets would present a difficult policing problem. Depreciation charges reduce ordinary income and, at the same time, reduce the basis of the asset for purposes of determining gain or loss from its sale. Whenever depreciation charges exceed the actual decline in the value of a capital asset, its basis will tend to be lower than its market value; and if the asset is sold, its owner will realize a capital gain. If capital gains were taxed at the same rates as ordinary income, there would be no advantage in selling overdepreciated assets, since the tax on the gain would be the same as the tax saving on the excess depreciation. But in a country such as ours, where capital gains are taxed at a rate only half as high as the rate on ordinary corporate profits, a law which permitted used assets to be overdepreciated would open up extensive opportunities for tax avoidance.[45]

The major argument against the limitation is that it reduces, to some extent, the good effects which more liberal depreciation allowances were expected to have on plant improvement and modernization. Any measure that would increase the demand for second-hand equipment will ordinarily also increase the demand for new equipment, since the purchasers of the new machines expect to cover a part of their costs out of the proceeds they receive from the sale of the machines they are discarding. Thus, if the allowance of accelerated depreciation on old used equipment would increase the demand for such assets, this would make the allowance of similar treatment on new assets even more effective. As we shall see below, Congress was unwilling to extend the declining-balance formula to cover used as well as new assets, in its 1958 tax revisions, but it did offer a substitute in the form of an additional first-year depreciation allowance for small business.[46]

A third area of alleged discrimination against small business has been found in the special tax advantages accorded to those persons who are eligible for membership

[44] Select Committee on Small Business of the Senate, *supra* note 3, at 12.

[45] To prevent such tax avoidance in the case of "emergency" assets eligible for amortization over a 60-month period, taxpayers are required to report as ordinary income any gains from the sale of such assets to the extent that they reflect amortization taken in excess of normal depreciation.

[46] See p. 11 *infra*.

in pension, profit-sharing, or stock bonus plans, as provided for by section 401 of the Internal Revenue Code of 1954. Since it is not easy for a small corporation to set up and maintain plans that will qualify for these special benefits, the small businessman believes he has grounds for complaint, since this puts him at a considerable disadvantage in competing with larger firms for employees. He finds that he must spend more than the large firm to give his employees compensation that is equivalent to the salary and retirement benefits they could get from the competing concern. Moreover, in the case of the proprietorship, the individual proprietor cannot qualify as an "employee," and so cannot get favorable treatment for himself, even though he could manage to set up a pension plan for his employees.[47]

This would appear to be another case where an attempt on the part of Congress to ease the burden of high personal income tax rates has had an uneven impact. In effect, Congress has made it possible for the employees of certain corporations and other concerns with approved pension plans to shift a portion of their current income to their years of retirement. Other taxpayers, including self-employed professional men and small businessmen, would like to have the same privilege, and they have proposed legislation which would allow a deduction for contributions to voluntary restricted retirement funds.[48] Despite the strong support which this proposal has received from many congressmen, it has not been able to win approval in the Senate. Although its enactment has been supported as a small business relief measure, the number of small businessmen who would benefit from it would probably not be very great.

A great many of the small businessmen who appeared before the Senate Small Business Committee in 1957, had a more general complaint to make concerning the discriminatory features of the federal tax structure. They spoke feelingly of the difficulties encountered by the small businessman in attempting to comply with the tax laws and regulations as issued by the Treasury Department. As one witness put it:[49]

> When you dare not make a business move without your tax accountant at your right hand and your attorney at your left; when the independent American businessman is so entangled in rules, regulations and red tape, so that a good portion of his time and money must be spent in clarifying confusion, gentlemen, that is a tax too. And small business finds it a grevious one.

Frequent changes in tax regulations, as well as tardiness in their issuance, have also been the source of considerable complaint.[50] These practices, along with inconsistent

[47] Select Committee on Small Business of the Senate, *supra* note 3, at 10.

[48] These groups succeeded in getting House approval for the Self-Employed Individuals' Retirement Act of 1958, otherwise known as the Jenkins-Keogh bill; but this bill was not reported out by the Finance Committee of the Senate.

[49] *Hearings* 5.

[50] One instance of tardiness in the issuance of regulations affecting small business is found in the case of certain unincorporated business enterprises that were given the option of being taxed as corporations by the Internal Revenue Code of 1954. Four years later, the regulations governing the making of this election had still not been issued.

interpretations of the Internal Revenue Code resulting from nonacquiescence of the Treasury in judicial rulings, have been said to work special hardships on small business.[51] While complaints of this sort are not easy to evaluate, there can be no doubt that a tax structure as complex as the present one imposes very heavy compliance burdens on small enterprises.

IV

REDUCING THE TAX HANDICAPS OF SMALL BUSINESS

Most of the tax handicaps to which small business is said to be subject could be removed quite easily if this country were in a position to make a substantial reduction in taxes. It is mainly because taxes are so high that small business finds itself at a disadvantage in its competition with larger firms. If all businesses were taxed less heavily, the small firms would find themselves in a relatively stronger position financially, because they would be able to retain a larger percentage of their profits. Furthermore, if tax rates were lower, those provisions of the Revenue Code which tend to discriminate against small business would have a less severe impact. Unfortunately, Congress has not yet been able to allow the scheduled five-point reduction in the corporations income tax to go into effect. Therefore, for the relief of small business, it has had to confine itself to measures which are not likely to have significant revenue effects. Resort to such measures has, however, been a rather recent development.

During the early postwar years, when the prospects for lower tax rates were quite bright, proposals to create special tax privileges for small business were not widely supported. The Committee for Economic Development, for example, while recognizing that there were provisions in the tax system which were bearing with special severity on small business, did not believe that it was in the public interest "to invoke discriminatory taxation in favor of small business for the purpose of forcing funds into particular channels."[52] Instead, it recommended tax reductions and reforms that would be beneficial to all enterprises, and that would be especially valuable in removing handicaps that bear most heavily on small business. Reliance on general tax measures, it was thought, was likely to involve fewer economic, equity and administrative problems than would the use of special small business measures.[53]

With the outbreak of the Korean crisis in 1950, the prospects for substantial general tax cuts became dimmer; and it was not until 1954 that steps could be taken to give business some measure of relief from wartime tax burdens. In that year, the excess profits tax was allowed finally to expire, and new legislation provided (1) a longer loss "carry-back," (2) some relief to shareholders from "double-taxation," (3) more liberal depreciation allowances, (4) greater opportunities to expense research and development costs, and (5) some relief from the penalty tax on accumulated

[51] *Hearings* 193-94.

[52] RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE ON ECONOMIC DEVELOPMENT, MEETING THE SPECIAL PROBLEMS OF SMALL BUSINESS, A STATEMENT ON NATIONAL POLICY 43 (1947).

[53] U.S. DIVISION OF TAX RESEARCH, TREASURY DEP'T, TAXATION OF SMALL BUSINESS 4 (1947).

earnings.[54] Although none of these changes in the Revenue Code were strictly small business measures, the last two were probably more helpful to small concerns than they were to large ones. On the other hand, these 1954 revisions did little to help the new small business without sufficient income to be able to take advantage of them.[55]

When the President's Cabinet Committee on Small Business made its first progress report in August 1956, the budget outlook was believed to be sufficiently good to warrant a cut in the corporate rate. Accordingly, the Committee's first recommendation was for a reduction in the rate applicable to the first $25,000 of income from thirty to twenty per cent. This action, it was stated, would "help the smaller firms to retain earnings for financing expansion, or would give them some advantage in pricing."[56] The Committee also thought that the proposed rate reduction would encourage the formation of new businesses. In addition to this rate cut, the Committee recommended: (1) that businesses be given the right to utilize, for purchase of used property not exceeding $50,000 in any one year, the declining-balance formulas that were made available to purchasers of new property, in 1954; (2) that corporations with a relatively small number of stockholders be given the option of being taxed as if they were partnerships; and (3) that the taxpayer be given the option of paying the estate tax over a period of up to ten years in cases where the estate consists largely of investments in closely-held concerns.[57] The Committee thought that the first of these proposals would improve the financial position and outlook of many small businesses, that the second would particularly benefit small concerns having stockholders with very modest incomes, and that the third would reduce the pressure of heavy estate taxes on closely-held corporations, and so reduce the number of mergers and dissolutions.

President Eisenhower endorsed the last three of these proposals in a letter which he wrote to the Chairman of the Ways and Means Committee of the House of Representatives on July 15, 1957. In view of the less favorable budget outlook at that time, he was unable to recommend a cut in the corporate tax rate; but he did suggest that an ordinary loss deduction, up to some maximum amount, instead of a capital loss deduction, might be allowed on original investments in the stock of small companies.[58] The purpose of this new proposal was to stimulate venture capital investment by offering investors greater and more certain tax advantages from any losses they might sustain on such investments.

The Senate Small Business Committee went somewhat further than the President in the recommendations which it made for small business tax revision in January 1958.[59] While also favoring the partnership option for closely-held corporations,

[54] ECONOMIC REPORT OF THE PRESIDENT 79 (1954).
[55] Brown, Miller, Ritter, & Robinson, *supra* note 33, at 541 n. 13.
[56] CABINET COMMITTEE ON SMALL BUSINESS, *op. cit. supra* note 1, at 4.
[57] *Id.* at 4-5.
[58] ECONOMIC REPORT OF THE PRESIDENT 63 (1958).
[59] Select Committee on Small Business of the Senate, *supra* note 3, at 8-21.

accelerated depreciation for a limited amount of newly-acquired used assets, and the spreading of estate tax payments in the case of estates having substantial assets tied up in closely-held businesses, the Senate Committee made a number of new recommendations. The one which it thought would accomplish more than any other single tax adjustment toward permitting small business to grow and prosper was a deduction for income tax purposes for any business which increased its investment in inventory or depreciable assets out of income. This deduction was to be graduated so as to require the taxpayers to assume full responsibility for a portion of the expansion, and was to be limited to a maximum annual allowance of $10,000 for a firm investing $30,000 or more in eligible assets.[60] The Committee also recommended a retirement deduction which would relieve any taxpayer of taxes on reasonable sums set aside for his own retirement, an increase in the minimum accumulated earnings credit to relieve small business "from the more onerous restrictions imposed by the accumulated earnings tax,"[61] and certain changes in administrative policy which it thought would be helpful to small business.[62]

With these and other small business tax recommendations before it, the Ways and Means Committee began, early in 1958, to draft a small business tax revision bill. This bill, which was submitted to the House on July 16th, called for five specific revisions in the Revenue Code.[63] Following the suggestion contained in the President's July 1957 letter, the bill provided ordinary loss treatment (up to $25,000 a year, or $50,000 a year in the case of a husband and wife filing a joint return) where the original holder of small business stock might sell it at a loss. The bill also raised the accumulated earnings credit from $60,000 to $100,000, thereby increasing the amounts which a business could accumulate over a period of years without the possibility of the imposition of any accumulated earnings tax. And, in line with the recommendations made by both the President's Cabinet Committee and the Senate Small Business Committee, it provided that where the estate of a decedent consisted largely of an interest in a closely-held business, the estate might have up to ten years for payment of the federal estate tax. But instead of granting accelerated depreciation for newly-acquired used assets, as had been recommended by these committees, the bill provided for an initial twenty per cent write-off for all tangible personal property, whether new or old, with the total amount of acquisitions eligible for this treatment limited to $10,000 a year, or $20,000 a year in the case of a husband and wife filing a joint return. Finally, the bill extended the net operating loss carryback from two to three years.

Following its approval by the House of Representatives, the Small Business Tax Revision Act of 1958 was sent to the Senate, where it was referred to the Committee on Finance. When this Committee delayed reporting out this bill, it was offered as a Senate floor amendment to the Technical Amendments Act of 1958, and was

[60] *Id.* at 9. [61] *Id.* at 17. [62] *Id.* at 18-21.

[63] House Ways and Means Committee, *Small Business Tax Revision Act of 1958*, H.R. REP. No. 2198, 85th Cong., 2d Sess. 1-2 (1958).

ultimately approved as title two of that bill.[64] The Technical Amendments Act itself contained a number of provisions which were intended to be helpful to small business. One of these granted certain small-business corporations the option of being taxed as partnerships,[65] while another provided that investment companies established under the Small Business Investment Act of 1958 should be allowed an ordinary loss deduction, rather than a capital loss deduction, on losses realized on any of the convertible debentures they might acquire in supplying long-term equity-type capital to small business concerns. Furthermore, persons subscribing to the stock of these investment companies were allowed an ordinary loss deduction on losses arising from the worthlessness, or from the sale, of such stock. Finally, the investment companies themselves were granted a deduction for 100 per cent of the dividends received from taxable domestic corporations, rather than the usual eighty-five per cent.[66] Thus, after some ten years of repeated urging, Congress has given small business some of the tax relief for which it has been asking.

V

CONCLUSIONS

In drafting this country's tax laws, Congress has never had any intention of discriminating against small business. Indeed, for many years, it has favored small corporations by moderately graduating the rates at which corporate income has been taxed. Nevertheless, there is some evidence that the high taxes which have been imposed on most businesses during and since the last war have hurt many of the smaller concerns more severely than they have the larger ones. Unless it has been expected to have spectacular growth, the small dynamic business has been handicapped by its inability to retain and reinvest its own earnings. At the same time, high personal income taxes have dried up many of the sources from which small concerns used to draw their outside equity funds. While the appreciation-minded investors are still willing to finance ventures where growth prospects are extraordinarily bright, they appear to be less interested in situations where only moderate rates of growth can be promised. In the second place, high taxes appear to have given considerable impetus to the postwar merger movement which has swallowed up so many small growing concerns. In the face of very high income and estate taxes, the owners of these concerns have found in mergers with larger corporations opportunities both to increase the liquidity of their estates and to realize in

[64] 72 STAT. 1606 (codified in scattered sections of 26 U.S.C.).

[65] The partnership option was intended to make it possible for small corporations which are essentially partnerships to enjoy the corporate form of organization without being made subject to certain tax disadvantages of the corporation. In those cases where small, closely-held corporations elect to be taxed as partnerships, the stockholders will be able to escape the double tax on distributed profits and will be able to deduct from their own taxable personal income their *pro rata* share of any losses which the corporations may sustain. Small businesses able to offer prospective stockholders these advantages should be able to attract capital funds somewhat more easily than they could have done under prior law.

[66] For a good general discussion of the Small Business Investment Act, see Federal Reserve Bank of Chicago, Business Conditions, Oct. 1958, pp. 13-16.

the form of capital gains income which had been reinvested in the business over the years.

In addition to being handicapped by high taxes, small growing concerns, and especially those which are relatively young enterprises, have probably not benefited as much as their larger competitors from certain wartime and postwar revisions in the tax structure, which were designed to help business generally. It appears that many such firms have been unable to take advantage of the favorable tax treatment accorded approved pension plans, of the right to accelerate depreciation charges on new assets, or of the right to expense certain research and development outlays. Finally, there would appear to be some merit in the complaint that the increasing complexity of the federal tax laws, and of the regulations of the Internal Revenue Service are in themselves an added tax burden which the smaller concerns feel more severely than do the larger ones.

The 1958 revisions in the Revenue Code should help in a small way to soften the impact of high taxes on the growth of small firms. By giving investors the tax benefits of ordinary losses when their investments in small business turn out badly, the risks they assume in making such investments will be somewhat reduced, and their willingness to invest accordingly increased. The granting of an initial twenty per cent depreciation allowance will enable profitable small businesses to recover more rapidly their outlays on new assets, and so make it possible for them to finance a somewhat larger part of their equity capital needs from internal sources. Extending the loss carryback period and permitting the spreading of estate tax payments should ease the liquidity problems of loss corporations and of estates in which a small business accounts for the bulk of the decedent's assets. But none of these changes in the law has significantly lifted the present-day tax burdens of small business. These cannot be lightened until we are in a position to make a general reduction in tax rates.

ECONOMICS OF DEFENSE PROCUREMENT AND SMALL BUSINESS

David Novick* and J. Y. Springer†

Since the end of World War II and particularly since the Korean incident, military procurement has achieved a peace-time volume never before contemplated in our history. This high level of activity and the likelihood that it will continue for a long time give defense spending a new importance in the national economy, and especially in selected industries—such as electronics, airframes, ships, or jet and rocket power plants. Under these conditions, it is logical that small business should seek participation in this new and large opportunity, since it always has been in competition to serve other kinds of economic demands.

This paper examines the magnitude and nature of military procurement and the special commercial considerations involved. The analysis concentrates on specialized military equipment and gives only passing attention to the problems of doing business with the military in such commodities as shoes, clothing, typewriters, meat and vegetable products, and a multitude of other items the services buy that are similar to or identical with standard articles of commerce.

The main concern of this study, therefore, is centered on the economics of procurement of weapons and the related and specialized equipment essential to their operation. It will of necessity include components, materials, special products, and services required for weapons and their directly related equipment.

This leads to consideration of the weapon-system concept of procurement management which has grown up in the last four years. Although the emphasis is on the economics of weapons, it is essential to take into account the national security considerations which compel a distinction between the market for these goods and that which prevails in normal commercial contracts.

Special contract and legal considerations are not included here. Instead, this paper deals only with the economic and national security considerations and does not treat with either the legal or moral issues involved.

I

Magnitude of Defense Procurement Since 1940

The national annual volume of business has expanded fourfold since 1940; during this same period, national security expenditures have expanded at a much more rapid

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rate.[1] From a level of $100,000,000,000 in 1940, the gross national product has grown to $434,000,000,000 in 1957, a growth of over 300 per cent. During this same period, national security expenditures which amounted to only $2,000,000,000 in 1940 had grown to $46,000,000,000 in 1957 or more than twenty times the 1940 level. The annual changes in gross national product and in national security expenditures over this eighteen-year period are shown in table one and portrayed in chart one below.

TABLE I
GROSS NATIONAL PRODUCT AND NATIONAL SECURITY EXPENDITURES, 1940-57
(billions of dollars)

Year	Gross National Product	National Security Expenditures	Year	Gross National Product	National Security Expenditures
1940	$100.6	$ 2.2	1950	$285.1	$18.5
1941	125.8	13.8	1951	328.2	37.3
1942	159.1	49.6	1952	345.4	48.8
1943	192.5	80.4	1953	363.2	51.5
1944	211.4	88.6	1954	361.2	43.1
1945	213.6	75.9	1955	391.7	41.3
1946	209.2	21.2	1956	414.7	42.4
1947	232.2	13.3	1957	434.4	45.7
1948	257.3	16.0			
1949	257.3	19.3			

SOURCE: U. S. Dep't. of Commerce, Survey of Current Business, July 1957, p. 9, and Feb. 1958, p. 8.

National security expenditures today represent a greater economic force than any other single major activity. The volume approximates the combined sales of the nine largest United States industrial corporations. It is greater than that of the automobile industry or the railroads. Only residential housing and public construction even approach in economic significance the military total. As a consequence of this magnitude of business, there has developed a new importance for the specialized firms doing business with the military in products like airframes, ships, and electronics, etc. Although the list includes many long-established large firms such as General Motors, General Electric, and Westinghouse, many other firms have developed a new economic importance in servicing the military in recent years. A few cases may be useful in illustrating this point. Table two demonstrates the growth and sharp fluctuations in sales volume by firms whose activity is chiefly in supplying the military. Chart two shows these data from 1940 through 1957 for several illustrative cases: an aircraft company, a shipbuilding firm, and an electronics manufacturer.

II

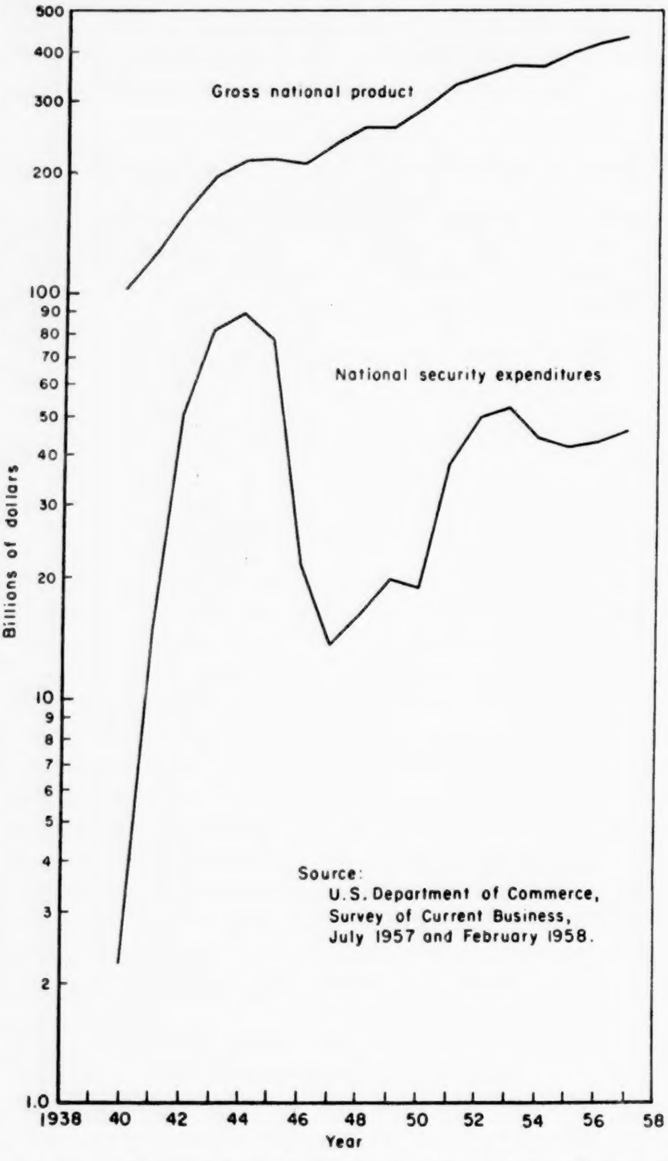
DOING BUSINESS WITH THE MILITARY

Although at first glance it might seem that doing business with the military would be no different from commercial transactions with other customers, closer scrutiny will indicate some highly specialized conditions which make considerations of

[1] The expenditure data cited here have not been adjusted for changes in the value of the dollar.

CHART I

GROSS NATIONAL PRODUCT AND NATIONAL SECURITY EXPENDITURES (UNADJUSTED)*
1940-57



* In order to compare the rates of change, the data are presented on a semilogarithmic, or ratio, scale.

TABLE II

NET SALES OF 25 COMPANIES WITH LARGE PROPORTIONS OF MILITARY BUSINESS, 1950-57
(millions of dollars)

Company	Total Military Contracts 7-1-50-12-31-55	Net Sales							
		1957	1956	1955	1954	1953	1952	1951	1950
Boeing Airplane Co.	$5957	$1596	$1006	$ 854	$1024	$ 912	$ 732	$ 337	$ 307
United Aircraft Corp.	4465	1234	954	699	655	818	668	418	270
Douglas Aircraft Co.	3992	1091	1074	868	915	874	523	225	130
North American Aviation Inc.	3631	1244	914	817	646	635	315	178	143
General Dynamics Corp.*	3517	1563	1083	731	764	693	618	482	372
Lockheed Aircraft Corp.	3308	868	743	674	733	820	438	237	173
Curtiss-Wright Corp.	2294	599	571	509	475	439	326	177	136
Republic Aviation Corp.	2270	269	346	547	324	412	412	130	58
Grumman Aircraft Engineering Corp.	1445	205	198	213	235	241	220	168	102
Sperry-Rand Corp.*	1406	871	711	699	690	632	468	350	252
Bendix Aviation Corp.	1342	711	581	567	608	638	509	340	219
Martin Co.	1191	424	359	272	271	208	144	68	40
Northrop Aircraft Inc.	985	281	322	283	172	184	187	90	44
McDonnell Aircraft Corp.	866	335	186	155	123	134	82	67	39
Alco Products Inc.	769	161	170	121	187	441	340	235	139
Kaiser Industries Corp.	765	376	266	164	212	359	203	146	238
Fairchild Engine and Airplane Co.	644	159	155	154	140	170	142	75	60
Bell Aircraft Corp.	503	202	216	204	186	146	129	82	36
Hercules Powder Co.	478	255	244	234	195	197	188	222	166
Raytheon Manufacturing Co.	434	240	176	182	177	179	111	90	60
Merrit-Chapman & Scott Corp.	432	348	365	360	146	70	45	51	38
Collins Radio Co.	399	124	125	108	90	80	64	19	13
Newport News Shipbuilding and Dry Dock Co.	393	178	118	123	150	157	147	89	52
Textron American Inc.	367	255	246	192	100	71	99	98	88
Vertol Aircraft Corp.	329	77	90	58	49	87	64	26	6

*Totals for General Dynamics Corp. and Sperry-Rand Corp. include totals of major merged companies prior to merger.

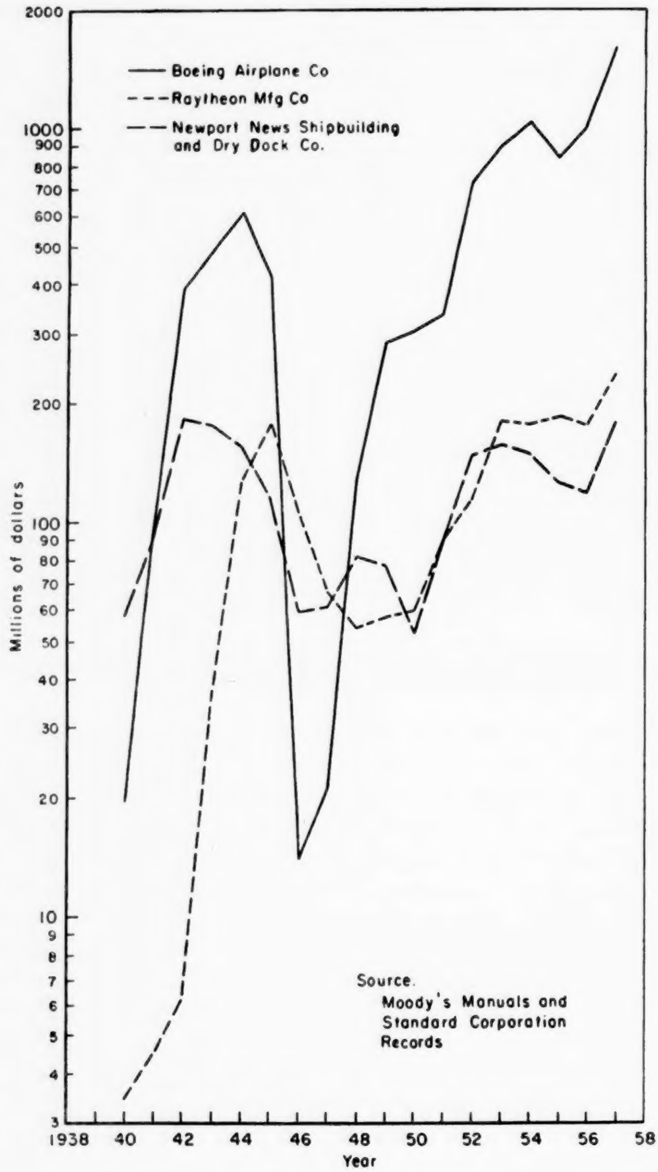
SOURCES: Sales from MOODY'S MANUAL OF INVESTMENTS STANDARD CORPORATION RECORDS; miiltary contract totals from House Select Committee on Small Business, *Final Report*, H. R. Rep. No. 2970, 84th Cong., 2d Sess. 171-73 (1957).

success or failure quite different in the military market from those in normal trade. These involve, for example, the kinds of goods and specifications for them required by the services, the multiple decision processes involved in placing orders, historical attitudes towards the selection of vendors, and the violent fluctuations in total volume resulting from changes in the thinking of the Executive or the Congress regarding the level of expenditures that should be permitted in support of the armed forces.

Knowing what the military wants usually involves more than just contacting the buyers and looking at periodically published lists of contracts to be let. In order to be equal to or ahead of our potential enemies, the military demands continually press against the outer perimeter of both the current and the expected state-of-the-art made possible by science and technology. This means that most of the items of equipment which the armed services want can be supplied only by vendors who engage in extensive and expensive research and development programs.

The growth in importance and cost of research and development in recent years has meant that very few companies can themselves undertake the financial risks involved and, as a result, that most of the research and development is financed by

CHART II
NET SALES OF THREE MILITARY CONTRACTORS
1940-57



the Government. Even if there had not been a well-developed practice of placing procurement contracts with the firm which had done the research and development, technical and financial considerations might have forced such a relationship. In any event, there are relatively few suppliers—if any—who could undertake the delivery of finished weapons on the time schedules required if they had not actively participated in research and development for the selected item or one closely related to it.

In addition to design and knowledge related thereto, pushing the state-of-the-art involves specifications with respect to precision, new materials, and new fabricating processing which, again, seriously limit the ability of many companies to compete. Although there is a tendency to think of such machine marvels as color TV and automatic gear shifts as new, if we stop and think for a moment, the older ones among us will remember the twenty years or more between the first projection of these ideas and their introduction on the commercial market. The military cannot wait twenty years for the performance reliability and reasonable cost which are more or less normal in the commercial realm. Even though the businessman must think of the possibility of a competitor getting the jump on him, he does not have to think of the devastating and horrifying results of an error in decision which confront the Joint Chiefs of Staff when they are for the first time presented with the scientific possibility of creating a revolutionary new weapon. Although there are conditions under which this new capability can be achieved just a few steps beyond the existing state-of-the-art, in most cases, the projection means moving in a few years to a point to which normal commercial evolution would have brought us in twenty or more years.

Partly because of the very advanced ideas, but to a larger extent because of the nature of the legal and administrative procedures established by the Government and the military, selling to the armed services is not a simple and straightforward task. The military cannot know the quantity of an item it wants until it has reasonable assurance of its performance. Since the capability is based upon [illegible] realization of an as yet unestablished state-of-the-art, no one can know how good or worthwhile the proposal is until after an extensive test program. Under these circumstances, decisions to buy are a mixture of optimism, knowledge, and willingness to take numerous types of risks. As research and development becomes more and more expensive, cost considerations have become increasingly important. In any event, it is not easy to get a yes-or-no decision with respect to either the item or its quantity.

Requirements for the item will be changed continuously, as hopes are tempered by experience. Quantities will go up and down as the pragmatic estimate of the value of the final product changes. This process would make life commercially difficult even if it occurred at only one point. However, in the case of the military, this process takes place in at least four or five places, and often more.

For example, decisions affecting the eventual procurement of military equipment may be first drawn up and reviewed at one or more levels in the using command, bureau, or corps. Decisions thus made are referred first to the military staff of the

appropriate headquarters in Washington and then to the Departmental Secretary's office. Those that survive are referred to the Department of Defense and, if approved there, to the Bureau of the Budget. It is apparent that this process will ordinarily require numerous interactions among the offices and agencies concerned, with resulting delays and extensive time lags, and that the final procurement decision will often bear little resemblance to the original proposal.

Against this multiplicity of military decision-making points, one can formulate his own estimate of the cost of representation and presentation which must be borne by the vendor in his search for military equipment business. When this is coupled with the other financial considerations involved and the necessity for having the mechanical and human capabilities to perform the job, it becomes apparent that substantial resources are required to do business with the armed services. Some measure of the magnitudes involved and particularly the changes which have occurred in recent years may be obtained by considering the changes in relative importance of research and development and procurement outlays for major weapons. Research and development costs for most types of World War II aircraft were ordinarily measured in hundreds of thousands or millions of dollars, with follow-on procurement outlays in tens or hundreds of millions. Research, development, and test on equipment such as the B-52 ran into millions, followed by procurement costs of billions. For the ballistic missile program, development costs (including test) are measured in billions and (depending on quantities of operational missiles procured) may even approach the ultimate procurement outlays.

Under present institutional arrangements, the real payoff to the vendor occurs only if the research and development effort can be converted into a procurement contract for the finished article. Three things are especially noteworthy: (1) the size of the research and development effort is, of itself, large; (2) the volume of procurement is so large as to require very substantial resources; and (3) the growth in research and development, together with the decline in the *relative* importance of procurement, makes the financial ability to enter into research and development a matter of prime importance.

The increase in the relative importance of the cost of research and development is impressive and overwhelming from a commercial point of view. Although unclassified data on research and development costs for individual weapons currently under development are not available, the Patman Committee published a list[2] of the companies and institutions receiving the largest amounts of military research and development contracts in fiscal years 1954-56. Table three shows these data for major companies whose business is primarily military, together with the companies' net worth in 1956. The magnitude of the research and development figures indicates that in many cases, the effort would be beyond the capability of a small firm and

[2] House Select Committee on Small Business, *Final Report*, H.R. REP. No. 2970, 84th Cong., 2d Sess. 171-73 (1957).

TABLE III

TWENTY COMPANIES WITH LARGE PROPORTIONS OF MILITARY BUSINESS: MILITARY RESEARCH AND DEVELOPMENT CONTRACTS AND NET WORTH

(millions of dollars)

Company	Military Research and Development Contracts Fiscal Years 1954-56	Net Worth 1956
North American Aviation	$421	$153
Boeing Airplane Co.	212	149
General Dynamics	169	143
Martin Co.	136	64
Bell Aircraft Corp.	134	39
Aerojet General	115	16
Northrop Aircraft, Inc.	105	28
Curtiss-Wright Corp.	98	183
Lockheed Aircraft Corp.	84	107
Sperry-Rand Corp.	83	254
Raytheon Manufacturing Co.	71	43
United Aircraft Corp.	67	219
Douglas Aircraft Co., Inc.	39	153
Bendix Aviation Corp.	34	177
McDonnell Aircraft Corp.	32	28
Chance Vought Aircraft	32	29
Republic Aviation Corp.	30	46
Fairchild Engine & Airplane Corp.	25	37
Thiokol Corp.	21	6
Ryan Aeronautical	17	11

*Parent corporations and subsidiaries not consolidated in all cases.
SOURCES: Research and Development contract totals from House Select Committee on Small Business, *Final Report*, H. R. Rep. No. 2970, 84th Cong., 2d Sess. 87 (1957); net worth from MOODY'S MANUALS OF INVESTMENTS.

that in others, if they were, indeed, undertaken and proved unsuccessful, the result would be financial catastrophe.

There may be some who will experience a feeling of dismay toward these high costs of research and development, especially when they may tend to drive smaller concerns out of the market as prime contractors. It should be recognized, however, that unlike production, where timing and volume can be calculated fairly well in advance, research and development is very often an attempt to exploit a chain of reasoning which rests in part on proved scientific principles, in part on plausible hypotheses, and in part on intuition or informed opinion on the part of specialists. Added to this usually are requirements for retention of high strength of materials under increasingly high temperature, finer and finer tolerances of fit, and the highest attainable level of reliability. The combination of all these means, in economic terms, the need to build and staff highly specialized laboratories and to support them for periods of unpredictable length, while a high-priced scientific and engineering staff, supported by skilled craftsmen, run down one promising lead after another. There is very little that is predictable in this process; there is no way of guaranteeing results.

In addition to the types of problems involved in selling the military which have been enumerated above, there is another and perhaps more potent condition arising from the nature of our annual budget-making process. In times of crisis, as in

World War II and Korea, there is a tendency for Congress and the Executive to make huge sums of money available to the military. When the crisis is over, there is a very real desire to cut taxes and move towards balancing the budget and, therefore, to cut back on military expenditures. The change in weapons procurement from 1940-45, as compared to 1945-50, is striking. In terms of what we can expect in the cold war, the changes that have occurred since 1950 are probably even more significant. (See chart one.)

From a commercial point of view, the important thing is the large volume of business and numbers of vendors that are brought in during the crisis expansion. When the cutback takes place, this naturally hits not only the established vendors, but more particularly the new vendors who have just gotten started. This means then that the usual changes in executive and congressional policy with respect to expenditures for military weapons produce a feast-or-famine condition which makes commercial survival extremely difficult. The sum of all these conditions means that it is not easy to do business with the military; this is reflected in the attitude of the bankers and the investment fraternity towards financing military vendors. Perhaps equally noteworthy is the oft-repeated attitude of companies who can employ their resources for nonmilitary purposes. After one or two sessions of doing business with the military, some will say, "never again."

III

Weapon-System Concept

Within the last few years, beginning notably with the Air Force procurement of the B-58 bomber in 1954, the so-called weapon-system concept has become important. The change here is particularly noteworthy, since it means placing the total system responsibility (excluding only power plant in the case of the B-58) in the hands of a single source. Prior to this time, the major components—such as airframe, bombardment-navigation system, or communications equipment—were bought from separate sources and were Government-furnished equipment to be incorporated in the final product by the airframe producer. Under the weapon-system concept, these items become contractor-furnished equipment, and a single vendor assumes complete responsibility for the total system. In varying degree, this concept has now been applied to other major Air Force procurements such as the B-70, the F-108, and the Atlas, Titan, and Thor.

There are two major reasons for this new way of buying weapons.

First, the mating or system-integration problem—that is, the combining of the various components into the final assembly—becomes more and more severe as weapon-system complexity increases. Obviously, when separate producers are developing each of the component items, in the course of the years that elapse from initial projection to delivery, the search for high performance may lead to departures from specification and configuration that will make mating well-nigh impossible. This becomes particularly important in airborne vehicles, where the search for weight

and space savings is extremely important and the configuration of the final structure has a marked effect on total performance.

Second, there are operational problems which cannot be taken fully into account in evaluating the separate articles. It is only as a total system that the equipment is operational and all the problems involved in both its airborne and ground handling activities become apparent. Let us develop these two points.

As the military moved toward the more and more advanced equipment, they have repeatedly encountered situations in which one component meets or exceeds the original specifications and another falls behind by a wide margin. Under these circumstances, the final system-integration usually produces an article which suffers from the lowest level of component achievement. To deal with this problem and to ensure greater compatibility of the components, the weapon-system concept has developed with the hope of insuring capability of the final assembly. There has been considerable discussion and negative criticism of this approach because it reduces the number of prime contractors and places a great deal of economic power in the hand of the successful bidder.[3]

Although this might be commercially undesirable, none the less the objectives and purposes of the weapon-system concept are desirable. If we can, in fact, achieve a more uniform state of progress, particularly in the sense that we can boost the laggards, and since the weapon-system concept seems to facilitate the joining program, there is much to be said in favor of this way of doing business. In a race for scientific and technical supremacy, it is important not only that each of the components be of advanced design, but more important that the final product be capable of the utilization of their separate achievements.

As indicated earlier, modern research and development has become very big business. In fact, as indicated in table three, the expenditures involved frequently far exceed the net worth of the designer. In addition, the skills involved usually go beyond the capabilities of a single company. As a consequence, there is now a tendency for various companies to form groups in which they bid on the weapon-system proposal. Under the newly developing scheme, each company takes its specialized part and makes a contribution both technically and resource-wise to the combine, although the end product is viewed essentially as a single weapon-system contract. The economic effect under the new condition is substantially the same as that of the previous method of weapon-system procurement management.

IV

ECONOMIC ROLE OF SMALL BUSINESS

According to data recently released by the Department of Defense,[4] about twenty per cent of the net value of all military prime contracts during fiscal years 1951-57

[3] For a discussion of the weapon-system concept, see NEIL E. HARLAN, MANAGEMENT CONTROL IN AIRFRAME SUBCONTRACTING 251-53 (1956).

[4] ASS'T SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS), U.S. DEP'T OF DEFENSE, MILITARY PRIME CONTRACTS WITH SMALL BUSINESS AND OTHER COMPETITORS, FISCAL YEAR 1957 SUMMARY (1957). In

have been awarded to small business firms. As indicated in table four, the proportion of military business going to small business differs markedly among the three military departments, amounting in fiscal year 1957 to about forty per cent for the Army, twenty per cent for the Navy, and eight per cent for the Air Force. This reflects the predominance of aircraft, missiles, ships, and other heavy equipment in Air Force and Navy procurement and, in Army procurement, the greater proportion of items not requiring large specialized manufacturing facilities.

The differences by type of commodity procured are shown more clearly in table five. As would be expected, the heavy concentration of awards to small business has been in civilian-type production—construction, textiles, and clothing, subsistence, and so forth. For major items of military equipment, small business participation in prime contracts (in fiscal year 1957) ranged from 13.5 per cent for ships to only 1.9 per cent for guided missiles and 0.4 per cent for airframes and related assemblies.

These percentages, it should be noted, reflect only *prime* contracts awarded by the military. If summary data were available showing small business' participation by way of subcontracts or through the sale of parts, components, materials, services, etc. to the prime contractors, the percentages would be very substantially higher for most types of major equipment.[5]

To the extent that small business wishes to expand its role as a prime contractor, it must be able to meet the economic requirements for doing business with the military which have been indicated in the preceding sections. This means being able to undertake the types of research and development essential to make equipment proposals to the armed services or having a sufficiently advanced manufacturing capability to meet the specifications for new materials, products, and processes if the design which the military requires has been developed by another firm.

For some types of products, particularly simple items of electronics and the like, small business may be able to compete. On the other hand, for most of the articles—particularly end items and major components—the resource requirement is so substantial that it is unlikely that a firm which meets the small business definition can be in a position to compete with large firms. In doing business with the military, the normal commercial difficulties are compounded by the multiple decision-making points which must give the go-ahead before the Government can proceed and by the difficulties of decision implicit in the projection of the state-of-the-art which characterizes most future weapons. This means continued representation and presentation on the part of the vendor, with the high costs and risks that go with it. Again, substantial resources are usually required.

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this compilation, "small business firms" are defined as "concerns which are not dominant in their fields of operation and which, together with their affiliates employ fewer than 500 persons, and those with 500 or more employees which have been certified by the Small Business Administration as small business firms."

[5] For a discussion of subcontracting in the airframe industry, see JOHN S. DAY, SUBCONTRACTING POLICY IN THE AIRFRAME INDUSTRY esp. 321-27 (1956); HARLAN, *op. cit. supra* note 3. For a statement of the Air Force policy, see *Hearings Before the Senate Subcommittee of the Committee on Appropriations on H.R. 12738*, 85th Cong., 2d Sess. 897, 907 *et seq.* (1958).

The historic practice of the military departments of giving a production contract to a firm that has done the research and development means that in terms of modern weapons, a potential supplier must be able to finance a substantial research and development effort. Although the Government eventually pays for most of these outlays, the problems of financing them are none the less real and are only possible for firms of substantial size. Again, the production of the finished articles reaches a dollar volume which is beyond the financing capacities of most small firms.

Even when the small firm, either by its own efforts or by entering into a combination with others, is able to meet the difficulties outlined above, it still runs an extraordinary risk resulting from our start-and-stop, stop-and-start policy on military expenditures. If there were a continuity either in the total volume or in dollars devoted to specific end products, it is possible that small business could work its way into military procurement just as it has into the supplying of commercial articles. However, when the Executive and the Congress change their minds so frequently, and with the volume impact that has taken place in recent years, the risks become almost unacceptable for the small firm.

Although the weapon-system concept has been singled out recently as a special ogre for the small businessman, it does not appear that this introduces any greater difficulties than are already presented in the existing system of military procurement. Even if it did, the primary objective of the weapon-system concept—that is, the earlier and more complete fulfillment of goals—would indicate that national security should be given first consideration in evaluating its impact on small business.

TABLE IV
SMALL BUSINESS PERCENTAGE OF MILITARY PROCUREMENT BY DEPARTMENT
Fiscal Years 1951-57

Fiscal Year		Total Military	Army	Navy*	Air Force
Total	1951-57	19.3%	32.3%	20.0%	7.5%
	1951	20.9	29.8	16.3	9.9
	1952	17.0	21.2	22.7	5.7
	1953	16.6	36.5	19.4	4.5
	1954	25.3	76.5	21.1	10.3
	1955	21.5	42.6	18.8	9.1
	1956	19.6	43.7	19.7	8.3
	1957	19.6	40.6	20.8	8.2

*Includes procurement actions of the Military Petroleum Supply Agency and its predecessor the Armed Services Petroleum Purchasing Agency.

SOURCE: ASS'T SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS), U. S. DEPT. OF DEFENSE, MILITARY PRIME CONTRACTS WITH SMALL BUSINESS AND OTHER CONTRACTORS, FISCAL YEAR 1957 SUMMARY 10 (1957).

CONCLUSION

The nature of modern weapons and their importance to the national security of our nation makes the economics of weapons development and procurement a primary national issue. As we push upon the scientific, technical, and fabricating states-of-the-arts, it becomes both more difficult and more expensive to meet the requirements

TABLE V

SMALL BUSINESS PERCENTAGE OF MILITARY PROCUREMENT ACTIONS OF $10,000 OR MORE WITH BUSINESS FIRMS BY PROCUREMENT PROGRAM

Fiscal Years 1955-1957

Rank	Program Title	Average for 1955-57	1955	1956	1957
1	Construction	66.8%	65.5%	71.8%	63.6%
2	Military Building Supplies	65.3	74.0	68.2	54.3
3	Textiles, Clothing & Equipage	60.2	50.7	67.2	61.3
4	Subsistence	52.9	52.7	56.0	50.3
5	Petroleum Containers & Handling Equipment	51.6	84.5	85.9	26.2
6	Fuels & Lubricants Other Than Petroleum	50.0	59.7	56.4	42.0
7	Construction Equipment	46.4	54.9	42.5	18.7
8	Miscellaneous Supplies & Equipment	44.1	43.6	41.1	48.0
9	Photographic Equipment & Supplies	36.0	35.8	40.7	31.2
10	Materials Handling Equipment	35.4	33.1	45.5	31.2
11	Medical & Dental Supplies & Equipment	32.8	38.1	29.8	31.2
12	Transportation Equipment	26.2	25.7	31.1	13.4
13	Petroleum	20.2	12.4	20.7	22.8
14	Non-Combat Vehicles	19.9	18.0	25.1	18.1
15	Services	16.5	36.5	12.3	9.7
16	Ammunition	15.6	15.0	18.2	14.4
17	Ships	13.7	15.7	12.5	13.5
18	Electronics & Communication Equipment	10.3	11.8	10.2	9.4
19	Weapons	9.9	12.1	11.3	6.1
20	Production Equipment	8.9	9.2	5.3	24.1
21	Miscellaneous Aircraft Equipment & Supplies	7.3	7.9	6.7	7.4
22	Combat Vehicles	4.4	4.5	4.5	4.2
23	Guided Missiles	2.2	2.9	2.1	1.9
24	Aircraft Engines & Related Spares	1.0	0.7	0.8	1.9
25	Airframes & Related Assemblies	0.4	0.4	0.2	0.4

SOURCE: ASS'T SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS), U. S. DEPT. OF DEFENSE, MILITARY PRIME CONTRACTS WITH SMALL BUSINESS AND OTHER CONTRACTORS, FISCAL YEAR 1957 SUMMARY 11 (1957).

for defending the country. The cost of research and development has reached major proportions. The investment required to do business with the Government is very large. Having the ability to supply the procurement demands for modern weapons thus involves very substantial resources on the part of the vendor.

Although military procurement is a major economic force in this country today, it does not seem possible quickly or easily to design the nature of this process away from large-scale enterprise. Even if some of the resource-demanding features such as representation and presentation were rationalized and made cheaper, two other conditions would make it difficult for small enterprise to compete. One of these is in the very nature of the process—that is, the tremendous resource requirement involved either in research and development or in production. The other is a political matter which neither the Executive nor the Congress has given any indication of an ability or willingness to solve—the stop-and-go or feast-or-famine programming of

funds for national security. It is not unlikely that from the small business point of view, this last is the most critical consideration. If the federal government were to lay on a long-range program for procurement of military end products, then small business might be able to find a way to get into the business. That means projections beyond the two and three years that we now make. Perhaps most important of all, it would require that we recognize the continuity of the preparedness effort and establish a minimum procurement level for something like the next ten years. If that were done, there would be a stability in the weapons business that would facilitate the appropriate commercial planning, and in such a situation, small business should be able to get its share.

SMALL BUSINESS IN GOVERNMENT-SPONSORED RESEARCH AND DEVELOPMENT PROGRAMS*

G. B. Kefover†

President Eisenhower established on May 31, 1956, a Cabinet Committee on Small Business. The President gave the Committee the continuing assignment of "making specific recommendations . . . for administrative actions, and where necessary for additional legislation, to strengthen the economic position of small businesses and to foster their sound development."[1] The Committee comprises the Secretaries of Defense, Commerce, and Labor; the Administrator of the Small Business Administration; the Administrator of the Housing and Home Finance Agency; the Director of the Office of Defense Mobilization; and the Chairman of the Council of Economic Advisers. A number of other agency heads also participate from time to time.

One of the findings of the Cabinet Committee, as expressed in its progress report to President Eisenhower dated August 7, 1956, has deep implications for the long-range future of many small business enterprises in the United States. The Committee found:[2]

> . . . the pace of technological change has been accelerating in recent years. Large and well-financed firms have been accustomed to undertaking costly research and development programs, which enable them to set the pace or meet the pace of industrial innovation and investment. Small business enterprises cannot normally do this.

In approaching this very difficult problem, it must be recognized that there is no "cure all" by which small business can be assured of maximum participation in all areas of federally-financed research and development. There are certain hard facts that cannot be changed by regulation or legislation. "Small" business by definition does not, in this advanced technological age, have the resources and facilities to undertake many of our nation's vital research and development programs. On the other hand, manpower and facilities for the conduct of research and development constitute a critically important national resource, and it is essential that the Government make the fullest possible use of nonutilized or underutilized research and development potentialities which may exist in small firms.

It is believed that much can be done to give the potential small business research and development contractor an opportunity to perform in this area to the limit of

* This article reflects the considered personal opinions of the author and does not necessarily represent the official position of the agency with which he is affiliated.

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[1] Letter from the President to the Honorable Arthur F. Burns, Chairman, Council of Economic Advisers, made public by the White House May 31, 1956.

[2] Cabinet Committee on Small Business, Progress Report 2 (1956).

his capabilities. With this objective in mind, I have outlined certain identifiable problems and how, in my judgment, they may be resolved, at least in part.

I

Conduct and Financing of Research and Development

The conduct and financing of scientific research and development in the United States is a phenomenon characterized by rapidly increasing magnitudes and complexity. Government research and development contracts are but a segment—albeit a large one—of the total picture, and it is impossible to understand and analyze the part without a general comprehension of the whole.

A major aspect of American culture and technology in recent decades has been the growth of research and development in the natural sciences. Scientific research and development is becoming increasingly essential to industrial progress generally, and, in certain industries to *survival* with respect to competing establishments. Likewise, the role of the federal government in science generally, and research and development specifically, has enlarged greatly since the beginning of World War II. The universities continue to play a very significant role in the conduct of fundamental research upon which ultimately depends applied research and development and, consequently, technological progress.

The National Science Foundation undertook a group of surveys on expenditures for research and development conducted by organizations in the various sectors of the national economy, with the year 1953 as a starting point. Among the more significant findings were the following:

1. $5,400,000,000 were spent on the conduct of research and development in the natural sciences in the United States in 1953. This figure, which does not include expenditures for capital equipment, was roughly 1.5 per cent of the gross national product of $363,200,000,000 for the same period.
2. As indicated in table one below, the federal government and industry-oriented organizations together provided more than ninety-five per cent of the financing of

TABLE I

The Four Sectors As Sources of Research and Development Funds and As Research and Development Performers, 1953 (Preliminary)

Major Sectors	As Sources of R&D Funds: Millions of Dollars	As Sources of R&D Funds: Per cent of Total	As R&D Performers: Millions of Dollars	As R&D Performers: Per cent of Total
Federal Government Agencies	$2,810	52	$ 970	18
Industry-oriented Organizations	2,370	44	3,870	72
Colleges and Universities	130	3	460	9
Other Institutions	50	1	70	1
Total[a]	5,370	100	5,370	100

[a]Detail may not add to totals because of rounding. Percentages are calculated on the basis of unrounded figures.

research and development. Funds from the universities and "other sectors" were less than five per cent of the total.

3. On the other hand, with respect to the *performance* of research and development, regardless of sources of financing, industry-oriented organizations accounted for almost three-fourths of the total.

4. The role of the university as a performer of research, though significant, is dwarfed *in dollar terms* by industry and the federal government; as a source of funds, it is insignificant.

5. Finally, more than half of the funds for research and development came from the federal government.

As the pace of technological advance quickens, the problems and subject matters to which scientific research is directed become increasingly complicated; they require increasingly complex and expensive instruments and equipment. The concept of a scientist using only his brain and simple "homemade" equipment has been outdated as a generalization. Without doubt, the speculative capacity of the individual researcher remains, and will continue to be, the most powerful and fundamental instrument of research. However, much of the spectacular scientific advance of recent years has been possible only through the utilization of complicated large-scale equipment, unknown in the decades past. It is, therefore, apparent that research is becoming increasingly dependent upon powerful, complex, and specialized types of research facilities, equipment, and instruments; and it is likely that the future progress of research will be accompanied by an increasing ratio of the cost of tools to the cost of manpower. Production of necessary particles for research in nuclear physics, for example, is dependent upon equipment such as the nuclear accelerator and the reactor, both elaborate devices. Research and engineering in many fields is dependent upon electronic computers for the solution of complicated or extended problems requiring weeks, months, or years with mechanical calculators. Biological research is necessitating electron microscopes which can make visible cellular arrangements and fibrous tissues not observable through conventional optical microscopes. Practically all areas of the physical and biological sciences are characterized today by an accelerating development of instrumental techniques permitting types of measurements and precisions which were not known a few decades ago. This progress has been made possible only through complex and expensive instrumentation. As the rate of technological advancement rises, the amount and quality of research that is performed in many areas is limited by the sheer expense of such instruments.

In essence, the foregoing boils down to the fact that the conduct of research and development in the United States by any governmental agency, firm, or other organization frequently requires large capital outlays for facilities and equipment. This is especially true in large-scale applied research and development projects in the fields of nuclear energy, aeronautical engineering, and weapon systems. Data are not at hand as to the magnitudes of capital outlays being made by private industry

for research and development. However, the presence of an upward trend is suggested in the Directory of Industrial Research Laboratories of the United States, published by the National Academy of Sciences—National Research Council. In 1950, the NRC Directory showed 3,333 laboratories of 2,845 companies. The 1956 canvass showed 4,834 laboratories and 4,060 companies.[3]

With respect to the university sector, preliminary returns from a survey of college and university physical facilities conducted by the Office of Education indicate planned outlays for undergraduate science laboratories in the next few years in an order of magnitude of around $300,000,000. The National Science Foundation has estimated that college and university requirements for graduate-level laboratories and specialized research facilities associated therewith will require a capital outlay in the range of $500-$700,000,000 over the next three to five years.

With respect to research facility outlays of the federal government, more data are available. In 1948, the Government's annual expenditure of funds to make physical facilities available for scientific research and development was $91,000,000. In 1958, $435,000,000 was expended for this purpose.

In addition to the two resources necessary for the performance of research and development discussed above—money and physical facilities—a third and most important of all—human resources—must be considered. The shortage of highly qualified scientists and engineers in the United States is well known. Relevant to this article is the manner in which this scarce resource is deployed among the various sectors of the economy and especially within industry. "On the basis of preliminary information from studies by the National Science Foundation, it appears that there are now about 250,000 persons employed at the professional level in the natural sciences. Nearly two-thirds of them are employed by private industry and about one-fifth each by higher educational institutions and by Federal, State, and local governmental agencies."[4]

Except for astronomers and biologists, private industry is the largest employer of natural scientists. Among the various fields, industrial employment ranges from about ninety per cent for metallurgists to approximately fifteen per cent for astronomers. Government, on the other hand, is the largest employer of biologists. About three-fourths of the estimated 700,000 engineers in the United States are employed in private industry; about one-fifth work for governmental agencies of all types; and probably two per cent, or less, are employed by colleges and universities.

In its surveys of research and development in industry, the National Science Foundation found that more than 550,000 engineers and natural scientists were employed in January 1954 in the surveyed industries.

A 1953 survey of research and development in United States industry produced several significant findings with respect to the role of small business. These findings

[3] National Academy of Sciences, Industrial Research Laboratories of the United States preface (Nat. Res. Council Pub. No. 379, 10th ed. 1956).

[4] National Science Foundation, Trends in the Employment and Training of Scientists and Engineers 6 (1956).

indicate that research and development is not confined by any means to the larger corporations, but they do indicate, as might be expected, that relatively greater emphasis is placed upon research and development by large companies than by the small establishments. The survey results which bear upon the distribution of research and development performance and manpower by size of firm are discussed in detail below.

Slightly more than 15,500 companies conducted research and development in 1953—exclusive of firms with less than eight employees and also exclusive of medical laboratories, scientific and engineering consulting firms, and a few other types of private businesses outside the scope of the survey. This estimate of the number of companies engaged in research and development is far above the top figure suggested by the most comprehensive previous data, primarily because this survey included a sample of small firms which were inadequately represented in earlier statistics of industrial research activities.

The great majority of companies participating in research and development are small. Of the nearly 14,000 manufacturers with research and development programs in 1953, about eighty-six per cent had fewer than 500 employees. However, when actual expenditures for research and development are analyzed, the concentration of research and development effort in the large companies becomes much more apparent.

How large a share do small companies have in scientific and engineering employment? Are scientists and engineers concentrated in large corporations to a greater or less extent than workers in general? Companies with 5,000 or more workers employed relatively more of the scientists and engineers in manufacturing industries (about three-fifths in January 1954) than of all workers in manufacturing (about two-fifths). The proportion of the estimated total research and development cost for manufacturing industries accounted for by these large companies was still greater (over two-thirds). In contrast, firms with 8-499 workers employed only one-fifth of the scientists and engineers and accounted for one-tenth of the research and development cost, although they employed over one-third of all workers in manufacturing.

Since this is the first time comprehensive estimates have been made of the distribution of scientific and engineering employment by size of company, there is no evidence as to whether or not the moderate numbers of scientists and engineers employed in small companies reflect an upward or a downward trend in utilization of technical personnel by small business. The number of small companies employing scientists and engineers was substantial, however—much larger than the number engaged in research, though quantitative estimates are not available on this point.

In general, small companies utilize relatively more of their scientists and engineers in nonresearch activities than large corporations. Thus, the proportion of scientists and engineers engaged in research was approximately thirty-one per cent in companies with 5,000 or more employees, compared with twenty-eight per cent in those with 1,000-4,999 employees and slightly under twenty-five per cent in those with less than 1,000 employees. This differential is one of the main reasons for the greater

concentration of research and development cost than of scientific and engineering employment in large companies, but it is not the only causative factor.

II

Some Handicaps of the Small Businessman

In assessing some of the implications of the Cabinet Committee's finding as to the handicaps which face small enterprise in keeping pace with technical change, it may be helpful to consider first some general United States economic trends as they relate to or are affected by research and development. The following points are worth noting:

(1) United States industrial technology has advanced to such a stage that continued progress in the production of new materials, devices, systems, methods, designs, and processes is dependent upon intensive research and development.

(2) Consequently, research and development is becoming an increasingly significant aspect of the industrial economy and of American culture.

(3) In turn, research and development is becoming increasingly essential to the survival of competing establishments in many industries.

(4) The advancement of science is rendering more complex the performance of research, necessitating increased specialization of research effort; fields of science continue to subdivide and specialize as new discoveries open up entire fields for further exploration and exploitation. This trend has been accompanied by increased reliance upon "team" as contrasted to individual research. In other words, a research problem frequently has facets extending into several different specialties and subspecialties; and in lieu of attempting to cover them with one or more "generalists," a team of specialists is formed to carry out a co-ordinated attack on the problem.

(5) Likewise, as the subject matters to which research is directed become more complicated, the physical facilities and equipment required for research become commensurately complex, and it is likely that the future progress of research in industry, as elsewhere, will be accompanied, in many fields, by an increasing ratio of the cost of tools (*i.e.,* facilities and equipment) to the cost of manpower.

(6) Furthermore, at the present time, the supply of qualified research scientists and engineers is not keeping up with the demand, with the result that not only are higher salaries required to attract these personnel, but they are becoming more difficult to obtain at any price.

(7) Therefore, the conduct of research, which with increasing frequency involves the establishment of a research *organization* or *team* consisting of high-priced and highly specialized talent along with complex and costly facilities, is tending to require heavy initial capital outlays. More important, since research and development by nature is an overhead rather than a direct manufacturing expense, a large income from sales is frequently a requisite

justification for the conduct of research and development by a manufacturing establishment.

Within the above general framework, some observations can be made regarding economic and other factors which influence directly, and largely tend to inhibit substantial research and development undertakings by small business firms.[5] Some, perhaps most, of these generalizations can be challenged, especially by pointing to outstanding exceptions. Nevertheless, they are submitted as indicative of some of the serious problems facing small enterprises which are endeavoring to meet the pace of technological change which is set by their larger brethren.

As stated earlier, the establishment of a research and development organization is requiring increasingly heavy capital outlays, which, in turn, usually requires a sizable sales volume to justify and make possible such an outlay. In addition, and regardless of financial outlay required, a complicated facility or a team of specialists frequently cannot be utilized effectively or at anywhere near a full-time basis by a single small firm. Furthermore, the commonly referred to "creative scientific environment," which is absolutely essential to advanced research, is not often found and is difficult to establish within the confines of a small enterprise. There are many noteworthy exceptions, but the generalization is advanced nevertheless.

Consequently, small firms may find it necessary to "purchase" research from commercial laboratories, research institutes, and other organizations (including suppliers of raw materials or semifinished products), rather than undertaking research and development within their own firms.

However, the "payoff" of research is very frequently found in terms of completely new lines of inquiry which may be opened up in the course of investigating a particular problem. These discoveries, upon further pursuit, may, in turn, open up completely new materials, products, or processes which, after perfection and development, constitute new "product lines" for the parent organization. It is for this reason that many large firms set aside a significant portion of their research and development budget for "undirected" or "blue sky" research to be undertaken at the initiative of the research and development department—with the full confidence that over the long run, the new knowledge gained will pay off in terms of new or greatly improved products and advanced skills of their scientists.

The "purchase" of research from other organizations by small firms, while affording on a contractual basis access to and service by adequate research facilities and manpower, does not afford the payoff from "by-products" of specific research projects which is enjoyed by firms having adequate research and development organizations of their own. Stated another way, the conduct of research by a firm tends to build up its "scientific capital"; if the research is purchased, the scientific capital created

[5] The economic and other factors discussed here obviously do not apply in the case of small *research and development* firms, where the conduct of research and development is the sole or primary business of the firm.

through "by-products" of research accrues to the seller rather than the purchaser of the research.

Trade associations, made up of both large and small firms, perform a moderate amount of research, the results of which are made available to members. However, trade association research tends to be concentrated in problem areas not being covered, or not susceptible of being covered, by research activities of individual members. Consequently, a small firm cannot necessarily depend upon the trade association for the performance of the same kind of research which is available to large firms through their own research and development departments.

Financial exploitation of research results often depends upon the patent system; in fact, the purpose of the patent system is to encourage research and invention by affording to the inventor a temporary monopoly in exchange for making public the results of his research. However, as our technology has become more complex, the obtaining, utilization, and protection of a patent has become more complicated, both scientifically and legally. To obtain a patent, to administer it through licensing or other arrangements, and to protect it against infringement requires considerable time, money and know-how. This, in turn, often requires investment in relatively high-priced talent.

To the extent that participation in research and development contracts of the federal government constitutes an advantage in obtaining subsequent hardware procurement contracts, those small firms not engaging in research and development or not participating in federal research and development contracts may on occasion find themselves at a disadvantage in bidding on federal procurement contracts.

Criticism by the small business firms with respect to the inadequacy of advance notice of government procurement of supplies and services has been prevalent for many years and requires no recitation here. Such complaints, whether justified or not, are still heard frequently, despite the many steps taken by federal agencies to achieve widespread dissemination of procurement information throughout the entire business community. This problem assumes particular difficulty and complexity, however, with respect to the purchase by the Government of research and development work. A considerable portion of such work is so abstract or exploratory in nature as to render impossible the advertising for bids on a competitive basis.

Furthermore, in the case of research and development, the Government is more often than not in a position of being able only to state a problem, with the development of "specifications," so to speak, dependent upon what potential contractors are able to come up with in terms of possible attacks on the problem. Consequently, a "chicken and egg" dilemma frequently confronts both the Government, on the one hand, and the potential contractors, on the other. The Government has the problems, and the potential contractors may have the ideas provided they know the problems. The large firms dealing with the Government on a continuous basis with respect to hardware procurement and those firms already having research and development contracts are generally aware of the fields of activity in which new research and

development are desired. For others, however, searching out the information may not be easy.

Constructive steps are underway by certain technical services of the military to better publicize their areas of research and development interest. The Air Force, for example, by its ARDC—AFPI Supplement 80, outlines its procedures for assisting small business concerns to participate in the research and development effort. Intensification of these efforts would not only be conducive to better opportunities for small business participation in research and development contracts, but would also provide the Government with a larger reservoir of potential contractors.

A further constructive step, in my opinion, would require that federal agencies engaged in contracting for research and development prepare and disseminate periodically on a broad base, descriptive booklets and other materials indicating in as much detail as feasible the research projects and programs being financed by the agencies, with a further indication of the specific areas in which research proposals are desired or encouraged.

Converse to the problem discussed above is the lack of information among federal agencies of the research capabilities of small firms.

Although small business is generally following the most *logical* course to present its capabilities in the research and development field, I believe that it is relatively *ineffective*. This method consists of a simple brochure outlining the facilities available to the firm; a listing of technical personnel on the payroll, with their respective qualifying backgrounds; and a statement of the firm's financial position. These brochures are given an average amount of distribution to research and development procuring activities, but once submitted, in most instances, they are treated in the same manner as requests for invitations to bid—*i.e.*, available for reference purposes if required.

With respect to research and development, however, these brochures all too frequently reside in the files of the contracting officer and do not get to the attention of the technical specialist who is "calling the shots" as to firms which should be invited to submit research proposals on a given problem. This points up one of the many problems of communication existent between technical specialists and contracting officers. The need for government-sponsored research and development, by reason of its very nature, is generated within a technical area of the agency. The contracting officer is generally not technically qualified to determine the full scope of research and development effort needed in the contract performance; therefore, he must place full reliance upon advice received from the government scientist. Unfortunately, however, the government scientist is inclined to rely almost entirely upon personal knowledge or contacts he may have within industry as to where qualified scientific personnel and know-how is available for the fulfillment of his project or program. As previously stated, scientists and technicians in industry are concentrated in large business firms. Consequently, the personal contacts of the

government scientist may, more frequently than not, lead to contract placement with larger and better known organizations.

In addition to the foregoing, there are also very logical reasons why the contracting officer would tend to place the contract with a larger organization of proven technical capabilities as well as an ability to operate within the complex accounting framework required by such a contract. In the first place, the contracting officer, more likely than not, will tend to rely heavily on "safe"—that is to say, large—businesses to the exclusion of qualified small businesses, even where the latter might produce fully satisfactory results. If a large, well-known firm fails in performance, the contracting officer is not apt to be blamed because of poor contract selection. However, if a small business fails in performance, the contracting officer is more likely to be subject to criticism for poor selection.

In the opinion of many, this burden of responsibility on the contracting officer is the greatest single factor accounting for the small share of government research and development contracts going to smaller business. The contracting officers generally have no technical or engineering training. Rather than take chances on highly technical matters, they are likely to be cautious and deal only with companies with a record of proved performance. And if a smaller business has not established its reputation through past performance, it may never get its chance through the medium of a government contract. The burden of convincing the contracting officer of its ability to perform might be extremely difficult.

It has been found in discussion with successful small business research and development contractors that in acquiring government contracts, success has come only after many personal visits by the contractor or his staff to *technical* areas which are concerned with the specialty he has to offer. These contacts are not only time-consuming, but costly; and, of course, the average small businessman is at a disadvantage in establishing such contacts.

By its very nature, research and development effort does not normally lend itself to the solicitation of bids in the sense that one usually considers bid solicitation. However, a contracting agency in this area of procurement must have some method available for the placement of research and development contracts. One method which has been criticized by small business contractors is the solicitation of informal quotations. It is contended that much expense is made necessary by this method, since the preparation of such quotations requires a definite engineering study and practically a solution on paper of the problem presented.

It has been contended that, in certain federal activities, practices governing the processing of security clearances are such that, in order to be processed for clearance, a firm must have been selected for a contract award. On the other hand, a firm not having security clearance would not be able to find out enough about a classified problem to be in a position to submit a research proposal.

Allegedly, too, in some instances, ideas or technical approaches presented in proposals by an unsuccessful applicant for a contract have been passed on to, and used

by, the successful contractor. These allegations continue to be made despite the provisions of section 3-109 of Armed Services Procurement Regulations, which specifically prohibit the unauthorized disclosure of data contained in research proposals. A further strengthening and full enforcement of such prohibitions would appear to be in order.

In any discussion of the relative participation of small firms in government procurement, a mandatory "set-aside" for small business comes immediately to mind. Establishment of a mandatory percentage of federal research and development contracts which should go to small business would be unworkable and not in the national interest. Each federal agency is assigned a specific mission and is enjoined to carry out its mission as effectively as possible. Whenever an agency contracts with an outside concern to assist the agency in carrying out its mission, the contracting officer's primary responsibility must be to assure himself that the award of the contract to a specific concern is in the best interest of the Government—that the award made to that concern is the most effective way for the agency to carry out its statutory objectives.

In the case of normal supply or construction contracts, it is possible to draw up specifications that permit several concerns to be considered when awarding a contract. If the Government desires to favor small business in making such awards, there is no loss in the effectiveness with which the agency is carrying out its mission—the specifications drawn up beforehand make certain that all proposals are on an equal footing with respect to performance.

This is not true for research and development contracts. In selecting a particular concern to conduct research and development work, the agency must determine that the probability for success is greater with the selected concern than with any other. Judgments must be rendered by individuals or boards responsible to the agency to make certain that the award to a specific concern will most effectively carry out the assigned mission. If it were mandatory that a fixed percentage of research and development work be awarded to small business, an agency would thereby be prevented from carrying out its mission in the most effective manner.

On the other hand, it must be recognized that technological trends are dictating the integration of much federally-financed research and development work into larger and larger prime contracts—namely, the "weapon system" approach. The interrelationship of weapon-system major components is such that the placement of contracts with large companies is inescapable.

There are no statistics available to determine the degree of participation of small business as a subcontractor to the large research and development prime contractors. However, subcontracting offers a means of increasing the small business participation.

Almost all research and development contracts are of the cost-reimbursement type. The reason is evident, since a research and development requirement cannot be spelled out in the same manner as "hardware." This introduces the requirement

on the part of the Government to verify a research and development contractor's "cost" under the contract, and, in turn, leads the Government to demand, for accounting purposes, records which generally exceed those needed by small business for their normal management purposes.

In negotiating a contract, the Government must first determine the contractor's financial stability and whether or not his accounting system will reflect every increment of cost, both direct and indirect, that will be incurred in the performance of the contract. This would appear to be a simple matter but, in fact, is most complex, since the allowable cost must come within a prescribed framework of allowable costs as determined by regulations which, of necessity, are but broad guidelines. These numerous cost determinations introduce a judgment factor initially for the contractor and subsequently for the auditor and the contracting officer.

III

SOME PROPOSALS

A variety of economic factors, it has been pointed out, are tending to inhibit, and often prevent, the undertaking of research and development by small business firms. While this problem is broader in nature than the degree of small business participation in federal research and development contracts, it is basic, nevertheless, to the question as to whether small firms can, in fact, become a significant reservoir of research and development talent for government-sponsored work. This leads one to consider the possible pooling of financial resources by small firms for the conduct of research and development. Such a plan could conceivably be outlined as follows:

1. *Objective*

To set in action countervailing influences upon those economic and other factors set forth above which militate against small businesses by enabling the establishment of a mechanism whereby small business firms in a given industry may pool their financial resources for the creation of a strong research and development organization designed to provide to member firms the same kind of direct *and indirect* benefits from research and development as are afforded by research and development departments to individual, large firms of which they are a part.

2. *Membership*

Membership would be open-end, but limited to firms coming within the federal government's definition of "small business." Firms growing to a size beyond "small business," as so defined, would be deemed to have "graduated" and would not be eligible to continue as members.

3. *Incorporation*

The organization would be incorporated as a profit organization under the laws of an appropriate state. It could be established on either a mutual or a stock-ownership basis, with transfer of stock limited to members or those eligible to become

members. The members or stockholders would elect a board of directors which, in turn, would select and maintain appropriate management.

4. *Activities of the organization*

(a) To construct, acquire or otherwise establish laboratories and other capital facilities for the conduct of research and development.

(b) To collect research information related to the industry and disseminate such information among member firms.

(c) To conduct applied research and development on a protected, proprietary, contractual basis with member or nonmember firms, government agencies, or others. (In other words, the organization would be free to undertake research on a sponsored or contracted basis when and if it desired to do so.)

(d) Conduct applied research and development on its own initiative and share information related thereto among members.

This would be the most important activity of the organization. It would pursue lines of inquiry deemed most promising from the standpoint of its own patenting and licensing activities, as described hereafter, and from the standpoint of greatest ultimate benefit to the members or stockholders. On occasion, it might undertake basic research or contract with universities, commercial laboratories, or other organizations for the conduct of specific research projects.

(e) To prosecute applications for patents or inventions or discoveries arising from research initiated by the organization.

(f) To negotiate and grant licenses, receive royalties, and otherwise administer and defend patents owned by the organization. This might include the establishment of subsidiary corporations designed to exploit particular patents obtained by the organization. It would also include negotiation with firms (large or small, members or nonmembers) regarding the interchange of patents and the cross-licensing thereof.

(g) To render a patent service to member firms which would include keeping continually informed of the patent situation in the entire industry and advising member firms relative thereto.

(h) To afford to member firms a facility for prosecution and administration of patents similar to that afforded to universities by the Research Corporation.

Specifically, a member firm which, in the course of research carried on by the firm, made discoveries which it felt might be patentable could negotiate with the organization with a view toward turning over the discovery to the organization. If the organization felt the discovery to be a "good bet," it would take title to the information and apply for a patent in the name of the organization. If a patent were obtained, the organization would administer it and defend it in any future litigation. Profits accruing to the organization from the patent would be shared with the member firm.

This plan would not in any way inhibit patent activities which any member

firm decided to pursue on its own account. On the other hand, it would constitute an alternative to selling patent rights to a large firm in those cases where the small firm did not have the time, money, or legal talent to endeavor to defend and administer the patent in its own behalf.

5. *Financing of the organization*

(a) The organization should be a self-supporting profit organization. In the light of national policies directed toward stimulating the establishment of conditions more favorable to small business, and because of possible difficulties in raising the relatively large initial financing involved, an act of Congress might be desirable, which would authorize federal insurance (through the Small Business Administration or other appropriate instrumentality) of a private loan for the purpose of initial establishment.[6] Among other things, such congressional authorization should require as a condition of federal insurance that the organization be limited to small business firms in a particular industry.

In this connection, since the coverage of the organization would be intra-industry rather than interindustry in scope, the first such organization might be considered to be of a pilot character, additional organizations being established in other industries if the innovation proved successful. Perhaps the incentive of federal insurance of the initial loan would be necessary only in the case of the pilot undertaking.

The authorizing legislation might leave to the insuring agency the discretion as to which industry was selected for the first undertaking. Such a decision would no doubt be largely influenced by the degree of private financial support obtainable and the proportion of small firms interested within particular industries. Needless to say, the choice of the industry within which such a pilot operation is attempted would constitute a critical decision.

(b) The immediate goal of the organization would be profit-making in character, yet compatible to a maximum extent with the interests of the members. Profits resulting from operations of the organization and its subsidiaries (if any) could be disbursed as dividends to members in amounts proportionate to their contributions or stock ownership, plowed back into further research, or such combination thereof as determined by the board of directors, subject to the ultimate control of the membership.

[6] Another alternative, which would involve more direct and continued participation of the federal government, would be a pattern similar to the Research Associations in Great Britain, but limited here to small firms. In the United Kingdom, the Government several years ago authorized the establishment of industry research associations, open to any firm in the given industry, subject to payment of regular contributions. The Government and industry both contributed to the associations, with government support decreasing as industry support picked up. At the present time, the Government contribution has dropped to a low of 10% in the case of certain associations, with complete government withdrawal a definite possibility in several.

6. *Antitrust statutes*

While it might be argued that certain activities of the organization might tend to restrict competition among members, the competitive position of small firms participating in the organization vis-à-vis large firms in the industry would certainly be strengthened. Furthermore, any marked improvement in the situation of individual members would tend to push them out of the "small" category, after which they would no longer be eligible to participate.

THE REGULATORY COMMISSIONS AND SMALL BUSINESS

WALTER ADAMS*

And while the House of Peers withholds
  Its legislative hand,
And noble statesmen do not itch
To interfere with matters which
  They do not understand,
As bright will shine Great Britain's rays
As in King George's glorious days.
W. S. GILBERT, IOLANTHE

The independent regulatory commission ranks among America's least felicitous experiments in economic statecraft. Here, under the guise of public convenience and necessity, the government alienates a portion of its sovereignty to a private corporation through a grant of privilege. The grantee, although ostensibly a chosen instrument for the effectuation of some public purpose, actually is an independent proprietor, free to pursue his profit interests, make his own decisions, and circumvent as best he can the feeble restraints of the police power. This private-management-public-regulation hybrid makes for inflexibility, rigidity, and duplication of effort. More important, it invites corruption of the government itself. It creates a situation where private profit depends as much on the ability to influence the regulatory authority as on success in the market place. Executive talent is diverted from the task of organizing efficient operations to the task of influencing "public relations." The public pays the costs, while the regulating authority, at best, does little but obstruct.[1]

The public grant of private privilege is not a modern phenomenon. Long ago, under the Tudors and Stuarts, such grants led to abuse and corruption, the raising of prices and deterioration of quality, restraint of trade and prosecution of interlopers, dispensation with statute law, and extortion. Sometimes the Crown used its prerogative to grant monopolies[2]

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[1] *Cf.* WALTER ADAMS & HORACE M. GRAY, MONOPOLY IN AMERICA 39-72 (1955); EUGENE STALEY, WORLD ECONOMY IN TRANSITION 186-87 (1939). See also HENRY C. SIMONS, A POSITIVE PROGRAM FOR LAISSEZ-FAIRE (1934).

[2] HAROLD G. FOX, MONOPOLIES AND PATENTS 70 (1947). See also WALTON HAMILTON, PATENTS AND FREE ENTERPRISE 1-23 (TNEC Monograph No. 31, 1941).

for purely mercenary reasons, attempting to obtain either a cash payment or a share of the profits from the grant or dispensation. In the hands of the corrupt courtiers, the system of monopolies, designed originally to foster new arts, tended to become degraded into a system of plunder, for the holders of monopolies in some cases knew nothing of the arts and acted in the widest spirit of exploitation and extortion. In some cases the monopolies were sold to companies of merchants, who enhanced the price to the utmost ability of the purchaser. In practice, commercial operations were hampered by a number of the grants [and] . . . the tendency was towards a concentration of power in corporate hands, until free competition was practically destroyed, and almost all commodities were in the hands of a favoured few, who fixed prices, terms and conditions, on such bases as would return them the greatest profit. Of necessity the general body of the citizenry suffered.

In time, this network of mercantilist privilege was swept away by the tide of economic liberalism, and commercial freedom was accepted as a sounder principle for organizing society. The pretense—Adam Smith wrote and public opinion agreed—that monopoly charters for corporations "are necessary for the better government of the trade, is without foundation. The real and effectual discipline which is exercised over a workman, is not that of his corporation, but that of his customers."[3] Competition, not regulation, is the keystone to economic welfare. Government interference with the individual's choice of occupation or trade[4]

is a manifest encroachment upon the just liberty of both the workman, and of those who might be disposed to employ him. As it hinders the one from working at what he thinks proper, so it hinders the others from employing whom they think proper. To judge whether he is fit to be employed, may surely be entrusted to the discretion of the employers whose interest it so much concerns. The affected anxiety of the law-giver lest they should employ an improper person, is evidently as impertinent as it is oppressive.

After the lapse of a century, however, the liberal tide receded. New men, with a perhaps blunted perspective of history, chose to put musty wine in old bottles. In an age dominated by conservatives who had nothing to conserve and liberals hating liberty, they again turned to a system of state-created and state-protected privilege. Under the traumatic impact of the Great Depression, Americans accepted a new mercantilism which brought wide segments of the economy under the certification requirements of independent regulatory commissions.[5] Old commissions were given broader jurisdiction, new commissions were created, and "public convenience and necessity" became the shibboleth of the day.

To be sure, the regulatory statutes of the 1930's did not sanction the total abandonment of competition. The standards which were set up to guide administrative action ("public interest" and "public convenience and necessity") were indefinite, but as the Supreme Court squarely held, there can be "no doubt that competition is a

[3] ADAM SMITH, THE WEALTH OF NATIONS 129 (Mod. Lib. ed. 1937).

[4] *Id.* at 122.

[5] See, *e.g.*, Natural Gas Act, 52 STAT. 824 (1938), 15 U.S.C. § 717f (1952), as amended, 63 STAT. 501 (1947), 47 U.S.C. § 214 (1952); Motor Carrier Act, 49 STAT. 551 (1935), 49 U.S.C. § 307 (1952); Civil Aeronautics Act, 52 STAT. 987 (1938), 49 U.S.C. § 481d (1952); Federal Communications Act, 48 STAT. 1083 (1934), 47 U.S.C. § 307a (1952); Transportation Act of 1940, 54 STAT. 950 (1940), 49 U.S.C. § 153 (1952).

relevant factor in weighing the public interest."[6] In the transportation industry, said the Court, Congress has not made the antitrust laws "wholly inapplicable," nor has it authorized the regulatory agency "to ignore their policy."[7] In short, Congress provided for the regulation of competition, not for its elimination by administrative fiat.

Nevertheless, the effect of these regulatory statutes, regardless of congressional intent, was to narrow competitive opportunity and curtail market rivalry. Whereas the goal of antitrust policy was to promote competition by maintaining a large number of competitors, preserving freedom of entry, and preventing all sorts of coercive and collusive restraints on free market processes, the regulatory statutes—as interpreted by the commissions—generally worked in the opposite direction. The Interstate Commerce Commission, in particular, regarded the Motor Carrier Act[8] as a mandate for wholesale restriction of entry, generous approval of mergers, and patient toleration of rate-fixing. It adopted policies which are clearly restrictionist, anti-competitive, and protective. It concerned itself not so much with the protection of the public, as with the protection of the industry it is supposed to regulate. The impact of these policies has not only been prejudicial to the broad public interest, but has hit the small businessman with differential severity.[9]

Small business is peculiarly vulnerable to strangulation by regulation. It is often incapable of coping with (1) the time, cost, and red tape inherent in the administrative process; (2) the use of the administrative process as a weapon of competitive harassment; (3) differential or discriminatory standards followed by the regulatory authority; (4) regulatory restrictionism and suppression of competition; and (5) undue identification between regulators and regulatees. These handicaps are only illustrative of a more basic problem, viz. the inability of small business to battle on two fronts. In those regulated industries where there are no substantial economies of scale and where, in the absence of entry restrictions, small business could hold its own, the threat to survival is more administrative than economic. A small firm may be able to surmount the challenges of the market place, and yet be unable to withstand a hostile regulatory bureaucracy. It may win the battle of managerial efficiency and market rivalry, only to be destroyed by "administrative expertise."

I

Time, Cost, and Red Tape

As any poker-player knows, the fellow with a bankroll has the advantage. He can withstand temporary adversity. If some of his gambits fail, the chances are

[6] FCC v. R.C.A. Communications, Inc., 346 U.S. 86, 94 (1953).
[7] McLean Trucking Co. v. United States, 321 U.S. 67 (1944).
[8] 49 Stat. 551 (1935), 49 U.S.C. § 307 (1952).
[9] *Cf.* Select Committee on Small Business of the Senate, *Competition, Regulation, and the Public Interest in the Motor Carrier Industry*, S. Rep. No. 1693, 84th Cong., 2d Sess. 27-28 (1956).

that others will succeed. He has staying power. He can wait for the big moment. He can play without fear that a streak of bad luck will bankrupt him and put him out of the game permanently. The rules of the contest may be neutral, but the outcome is not unrelated to the resources of the participants.

The importance of delay and costliness of proceedings before regulatory commissions was forcefully demonstrated in recent hearings before the Senate Small Business Committee.[10] One witness reported that he had applied to the ICC in 1946 for authority to transport radioactive materials in interstate commerce. The hearing examiner had recommended that the application be approved. He had found that competent witnesses, including the traffic manager for the Atomic Energy Commission, supported the application. The hearing examiner concluded that there were "no other motor carriers engaged in this service," that this was "the first application for such authority," that no one questioned the applicant's "ability, financial or otherwise, to perform the proposed service," and that there was "no question of the need by shippers" for the transportation of radioactive materials requiring special handling.[11] Despite these findings by the examiner, filed in October 1947, division five of the Commission rejected the application. The applicant was informed that the Commission was formulating rules for the safe interstate transportation of radioactive materials, and that "as soon as such regulations are prescribed, an effort will be made to dispose of the . . . application as promptly as possible."[12] As of December 1955, however, the applicant was still waiting. After a lapse of nine years, in public testimony, a Commission official still expressed doubt "whether radioactive materials are yet a commodity that moves freely in commerce."[13] The Commission was still not prepared to act—despite the applicant's willingness to gamble on the existence of sufficient demand for his service, testimony by several shippers as to the need for such service, and the Atomic Energy Commission's recommendation that the rights be granted.

At the same hearings, another small company (operating six tractors, nine semitrailers, and three pickup trucks) related its experience in applying for additional authority to serve the towns of Boaz (population 3,078) and Albertville (population 5,037). According to the applicant, shipper witnesses told the ICC that[14]

> . . . there was no direct motor carrier service afforded by the large motor carriers between these points and Chattanooga and Birmingham. They also testified that it takes from 3 to 10 days to obtain freight service between these points and Chattanooga and Birmingham by those large motor carriers which now provide any service at all. None of the opposing motor carriers offered to provide direct service to Albertville and Boaz from either Chattanooga or Birmingham although many of them operate between Chattanooga and Birmingham regularly. The opposing motor carriers which have operating authority to serve Albertville or Boaz either serve these points by a circuitous route or interline the

[10] *Hearings Before the Select Committee on Small Business of the Senate on the Administration of the Motor Carrier Act by the Interstate Commerce Commission As It Affects Small Truckers and Shippers*, 84th Cong., 1st Sess. (1955).

[11] *Id.* at 433-35.

[12] *Id.* at 200.

[13] *Id.* at 432.

[14] *Id.* at 93-94.

traffic with a second carrier. This evidence led the joint board which heard the case to recommend the grant of authority to Bee Line to serve both Albertville and Boaz without restriction. The Commission, division 5, initially denied all authority to these points on the ground that these towns have "limited transportation needs" and that the service was not shown to be "so inadequate as to justify a grant of additional authority." On reconsideration, the Commission, division 5, denied authority at Boaz and between Albertville and Birmingham on the ground that the service of Roadway Express, Inc., was not shown to be inadequate even though the evidence of record demonstrates and the Commission's report shows that Roadway would handle such traffic through its Gadsden terminal, in effect interchanging with itself at Gadsden.

After 4½ years of proceedings, which cost the applicant more than $1,400, the Commission finally granted him limited authority to serve Albertville, but steadfastly refused to approve the extension of service to Boaz.

In the airline industry, 164 applications for regular trunk line passenger certificates were submitted to the Civil Aeronautics Board since 1938. Of these, 126 applications were either withdrawn or withered on the vine before a determination could be made. Not one of these applications was approved. Of the twenty-one nonscheduled carriers which applied in the combined *Transcontinental Coach* case,[15] only four survived till the end of the proceedings. "We are small businessmen," one of them told a congressional committee. "We cannot afford to pay the fabulous attorney fees to have a lawyer present at this hearing every day that it has been going on for six months now. . . . They are slowly chopping our heads off while that is going on."[16] Significantly enough, none of the four survivors made the grade. After twenty years of regulation, and despite a 4,000 per cent increase in traffic, there are four fewer trunk lines than when the Civil Aeronautics Act[17] was passed.

The large firm does not face these handicaps. It can afford to be persistent—in the hope, or with the knowledge, that it will eventually master the labyrinthine regulatory maze. The case of Allied Van Lines, the nation's largest carrier of household goods, is not atypical.[18] Beginning in 1942, Allied filed a series of four applications with the ICC in an effort to validate the nation-wide operations which it had conducted prior to the Motor Carrier Act. At first, Allied suffered a number of serious reverses. In 1943, the Commission rejected Allied's pooling proposal.[19] In 1945, to terminate antitrust proceedings by the Department of Justice, Allied was forced to accept a consent decree under which the Allied system was, for practical purposes, dissolved.[20] Individual Allied agents were free to make interline arrangements with one another (like any other carrier could), but Allied's co-ordinating role, and its power to make co-ordination effective, were precluded. Finally, in February 1946,

[15] Transcontinental Coach-Type Service Case, 14 C.A.B. 720 (1951).

[16] Bendiner, *The Rise and Fall of the Nonskeds*, The Reporter, May 30, 1957, p. 32.

[17] 52 STAT. 973 (1938), 49 U.S.C. §§ 401-681 (1952).

[18] Adams & Hendry, *Trucking Mergers, Concentration, and Small Business: An Analysis of I.C.C. Policy 1950-56*, in *Hearings Before the Select Committee on Small Business of the Senate on Mergers and Possible Growth of Concentration in the Trucking Industry*, 85th Cong., 1st Sess. 211 333-43 (1957).

[19] Allied Van Lines, Inc.—Pooling, 39 M.C.C. 287 (1943).

[20] United States v. Allied Van Lines, Inc., et al., Civil No. 44-C-30 (N.D. Ill. 1945).

the Commission denied Allied's application for "grandfather" rights, as well as the application for a certificate of convenience and necessity.[21] Allied seemed to have reached the end of the trail. It appeared that the Allied system was illegal in its conception and operation, that it was unfranchised, and that the Commission did not consider it a necessary or desirable element in the nation's transportation network. Then, in April 1946, the Commission, in effect, reversed its earlier Allied rulings, set aside the court's judgment in the antitrust proceedings, and approved Allied's operations on a nation-wide basis.[22] The Commission recognized that

> Insofar as competitors are concerned, it is doubtful that they will perceive any marked difference in Allied's operations after approval than before. . . .[23]
>
> Approval of the instant transaction would unquestionably give permanence to substantially the same arrangement that originated in 1928 and has grown to its present stature through a trial and error process. . . .[24]
>
> This is the fourth proceeding before us in which Allied Van Lines, Inc., has sought authority to continue substantially the same operations in which it has been engaged for many years. . . .[25]
>
> Despite some changes in form and detail, there has been no change in substance in the new Allied plan of organization and operation. . . .[26]

The ability of a powerful applicant to persist in pushing its proposals had obviously paid off. Early reverses did not bankrupt or discourage the applicant. On essentially the same economic facts, the Commission was eventually persuaded to reverse itself and to approve the application.[27]

The evidence on this score is rather conclusive. It shows that, in an administrative jungle, without stare decisis and res adjudicata, the firm with financial and market power has a clear advantage. Its operational efficiency may be no greater than that of its smaller rivals, but its power to sustain litigation efforts and expenses is unquestionably superior. Even if the law were enforced with intelligence and impartiality—an assumption not always consistent with the facts—the small business man would be seriously handicapped.

II

THE ADMINISTRATIVE PROCESS AND COMPETITIVE HARASSMENT

Much of the red tape and delay in administrative proceedings is due to the almost unlimited rights of intervention and protest which the commissions accord to parties with an only remote interest in a particular case. The right of protest is, of course, a safeguard for regulated firms against arbitrary and capricious administrative decisions. However, the exercise of this right is an expensive process—the cost of

[21] Allied Van Lines, Inc., Common Carrier Application, 46 M.C.C. 159 (1946).

[22] Evanston Fireproof Warehouse—Control—Allied Van Lines, Inc., 40 M.C.C. 557 (1946).

[23] *Id.* at 585.

[24] *Id.* at 592.

[25] *Id.* at 609-10 (concurring opinion of Commissioner Lee).

[26] *Id.* at 611 (dissenting opinion of Commissioner Alldredge).

[27] Further evidence to support this generalization is detailed in Adams & Hendry, *supra* note 18, at 343-50.

representation in prolonged proceedings can quickly become prohibitive—and in practice, the frequent use of this right becomes a luxury which only the largest companies can afford. Because of this, the right of protest has come to be used mainly by those firms which, by virtue of their size and financial resources, are least likely to be harmed by competitive pressures. Their frequent appearance as protestants suggests that the protests are a coercive and harassing weapon which they alone can use readily and which they can use to prevent the entry of new, or the growth of existing, competitors.

According to testimony before the Senate Small Business Committee, the delay, harassment, and bedlam which protests can cause at administrative hearings are unbelievable. An ICC practitioner told the Committee that at one hearing before a commission examiner, there[28]

were so many attorneys intervening that we had to move from a small to a large courtroom in the Federal courthouse. At one point, there were so many objections being made between the time a question was asked and a ruling by the examiner that by the clock it took more than 45 minutes. Under these circumstances it was impossible to present any testimony.

The practitioner's client told the Senate Small Business Committee:[29]

The procedure of the ICC . . . permits and even encourages all carriers to intervene and participate in all proceedings involving any other carrier, regardless of whether or not there is any clear or direct relation between the purpose of the hearing and the interest of the intervening carriers. Since the large carriers can and do maintain legal staffs simply for the purpose of carrying on such endless litigation before the ICC and since the small carriers cannot afford such uneconomic extravagance, this procedure by itself gives the large carriers a powerful weapon simply because of their size and wealth and which is completely unrelated to any principle. Furthermore, while the ICC complains that it is overloaded it actually multiplies its own work by making its own proceedings much longer and more complicated than they should be because of this unrestricted right of intervention. In our own case, this procedure has resulted in such confusion and harassment that it has actually prevented any orderly presentation of evidence. I think it is fair to say that *the procedures which the ICC has established present the small carrier with a type of modern ordeal by litigation.*

Not only is the large company in a more advantageous position than its smaller rivals for utilizing—indeed, perverting—the protest machinery, but it can do so with greater assurance of success. This emerges from a sample study of twenty-seven section five proceedings, decided between May 1951 and June 1955, and involving motor carriers of household goods.[30] The applicants in fourteen of these cases were

[28] *Hearings, supra* note 10, at 42.

[29] *Id.* at 47. (Emphasis supplied.) Other witnesses informed the Committee that certain motor carriers in New England are banded together in an organized group, generally represented by one attorney. Apparently, the attorney is retained on a monthly or yearly basis and is under instruction to protest every extension application which may remotely affect any of the participating carriers. As a result, the record is clogged with testimony which "is repeated over and over and over, in case after case, almost by rote, by professional witnesses" appearing for these organized protestants. *Id.* at 95.

[30] Adams & Henry, *supra* note 18, at 329-32.

"large" companies (gross revenues in excess of $2,500,000 in 1953); the applicants in thirteen cases were smaller carriers. In all, a total of forty-four carriers intervened as protestants to the applications. Nine of these appeared as protestants in three or more proceedings, while thirty-five carriers appeared in no more than two proceedings. Viewed differently, the forty-four protestant carriers intervened 123 times, but the nine carriers who appeared three or more times accounted for eighty-one interventions—almost two-thirds of the appearances in opposition.

The nine protestants appearing so consistently were, with one exception, among the twenty-five largest household goods carriers in the country, and six of nine ranked among the ten largest movers. Not only did these nine carriers intervene more often than all other protestant carriers taken together, but they intervened more often against their small than their "large" competitors. Seventy-two and eight-tenths per cent of their protests were against small firms, and only 27.2 per cent against "large" carriers. This was not true of other carriers appearing in protest. They divided their interventions against "large" and small rivals in roughly equal proportion (54.8 per cent and 45.2 per cent, respectively).

Finally, it is noteworthy that the protests directed against smaller carriers were strikingly successful. Of the protested proceedings in the sample, two-thirds involved small carrier applications, and of these, only twenty per cent received Commission approval. One-third of the protested cases involved "large" carrier applications, and of these, sixty per cent were approved. Thus, the "large" carriers had an advantage on two counts: (a) a smaller percentage of their applications was protested; and (b) even when protested, a larger percentage of their applications received Commission approval.

From this study, Professor Hendry and the writer concluded that a few large firms—at least in this segment of the trucking industry—have the financial power to carry on a continuous campaign of protest against their smaller competitors, and that this campaign is an admirable device for curbing the growth of the small firm. This type of competition via the administrative process is fully as important as competition in the market place. As Commissioner Mitchell concedes, many interventions "are not real protests—they are delaying actions."[31] They are a competitive weapon of harassment to which the small firm is peculiarly vulnerable, and against which it may well be defenseless.[32]

[31] Speech of ICC Commissioner Richard F. Mitchell before the Eighteenth International Convention of the Motor Carriers Lawyers Association, quoted in Transport Topics, May 28, 1956, p. 4. In this connection, former CAB Chairman Ross Rizley observed: "Private rights must be respected, but when protection of private interest reaches such a point that, for any case of reasonable size to reach decision, it takes months and months of hearings, and reams of irrelevant, repetitive, and frequently incompetent evidence; when it takes time, energy, and money spent on pressures to override the evidence introduced; when proceedings grow like cancer because of the need for protecting peripheral private rights . . . when all these elements combine, we lose sight of the basic reason for our existence, which is to assure to the public of the United States . . . an adequate, safe and successful air transportation system." *Some Personal Reflections After Eight Months As Chairman of the Civil Aeronautics Board,* address before the Chamber of Commerce, Enid, Oklahoma, Nov. 18, 1955.

[32] By way of a remedy, one small business man has suggested that "carriers protesting an application

III

DIFFERENTIAL AND DISCRIMINATORY REGULATORY STANDARDS

To the small businessman, regulation is more than a procedural challenge. The delay, costliness, red tape, and competitive harassment inherent in the administrative process are formidable handicaps, but these are compounded by the latitude of agency discretion and the frequent failure to use such discretion in a uniform, nondiscriminatory manner.

The ICC's merger policy toward motor carriers is a case in point. This policy, according to a content analysis of section five decisions, is vague, vacillating, and inconsistent—with the Commission apparently imposing a "double standard" in judging the merger applications of large and small carriers.[33] What is embraced in one opinion as the natural and inevitable result of the economic facts of life is rejected in another as not demonstrably in the public interest. Where the fears of competitors are glibly dismissed in one instance, the plight of competitors assumes decisive significance in another. When the Commission is intent on approving a merger application, it finds that nothing has been adduced to show the transaction is "contrary to the public interest." When the Commission wishes to deny an application, the standards shift and the merger is rejected because the transaction was "not shown to be in the public interest." The first test represents an effective rear-guard action by the Commission against protests; the second puts the full burden of proof on the applicant, with the necessary volume and quality of proof somehow always beyond his reach.

On the issue of "unlawful operations,"[34] for example, the ICC condemned a small carrier for merging without prior Commission approval and for failure to terminate the unlawful arrangement even after a control investigation was instituted. The Commission denied the merger application because the transaction had not been shown to be in the public interest—despite evidence that applicants were providing a less-than-truckload service for small shippers unmatched by the giant protestants. Said the Commission:[35]

> There is little evidence in this record to justify the actions of respondents in accomplishing the common control of these carriers without our authority, or which would warrant our sanctioning such control at this late date. There can be no doubt that the individuals concerned were aware of the provisions of the act. . . . [Nevertheless, even] after entry of the order of investigation, although an application for authority under section 5 was filed, the parties took no steps to end the relationship and operating practices which clearly amounted to control and management in a common interest, and, indeed, in the face of that order and after the first hearing, the remainder of the stock was purchased.

should be required to prove through their records that a definite injury would be sustained, and a hypothetical assumption on their part would not enable them to participate. They should prove that a given percentage of their business is or would be affected, and this percentage should be such that they would definitely prove a substantial interest in the case." *Hearings, supra* note 10, at 446-47.

[33] Adams & Hendry, *supra* note 18, at 218-19.

[34] *Id.* at 276-80.

[35] Cortland Fast Freight—Purchase—Korten, 60 M.C.C. 321, 329 (1954).

In effect, applicants would have us ignore the unlawful control which has now continued for some years, and authorize the merger on the basis of the evidence presented, which is largely based on the unlawful control and the operations thereunder and directed primarily to the merger. The real issue is whether the common control of these carriers should be sanctioned under the circumstances presented. In our opinion, this record shows such a flagrant disregard for the law that divestiture should be ordered.

By contrast, the Commission reprimanded, but did not condemn three of the four largest household goods carriers for the identical offense. North American Van Lines had engaged in unlawful control and pooling without prior Commission approval and had failed to terminate these arrangements when a control investigation was instituted.[36] United Van Lines had been in continuing violation from 1947 to 1955 and had wilfully ignored at least one prior Commission finding of unlawful conduct.[37] Allied had been in violation for at least three years and had continued operating in the face of a consent decree providing for the virtual dissolution of the Allied system.[38] Yet, the Commission ultimately approved all three applications—not because they were shown to be *consistent* with the public interest, but because they were not shown to be *contrary* to the public interest.[39]

With respect to the competitive impact of merger proposals, the Commission set up similarly inconsistent criteria. It approved numerous large carrier acquisitions on the grounds that the resulting increase in competition would yield public benefits without injuring protestant carriers. According to the Commission,[40]

Protestants generally are apprehensive that if the proposed transaction is approved and consummated they would lose some of their traffic to vendee. Their fears are based upon the opinion expressed by their representatives and there is no evidence of record such as exhibits or statistics supporting those opinions. The extent to which these carriers claim their operations would be affected is speculative and conjectural and in the absence of a showing with some particularity how much traffic they would lose or to what degree their operations would be harmed, their apprehensions may be accorded little weight in determining the issues here presented. It is probably true that the transaction will cause (and the operations under temporary authority no doubt have already caused) some readjustments in competitive relations of carriers, and an intensification of competition between points in the territory of vendor. This almost always occurs, to a greater or lesser degree, when the purchasing carrier is stronger financially, and from the standpoint of equipment and facilities, than the selling carrier; but we are not convinced that any of the protestant carriers would be unable to meet the added competition without serious impairment of their existing services. . . .

In considering small carrier mergers, by contrast, the Commission tends to emphasize the adequacy of existing service, to show solicitude for the welfare of large and established carriers, and to express ominous misgivings about the future

[36] North American Van Lines—Investigation of Control, 60 M.C.C. 701, 748, 751, 753 (1955).

[37] Geitz Storage & Moving Co.—Investigation of Control, 65 M.C.C. 257, 290, 293, 294-95 (1955).

[38] See *supra* notes 19, 20, 21, and 22.

[39] Adams & Hendry, *supra* note 18, at 279.

[40] Mid-Continent—Purchase—Hanson, 11 Fed. Carr. Cas. 212, 215 (1955).

stability of the industry.[41] In underscoring the protective role of regulation, the Commission characteristically argues that[42]

> We have stated in numerous cases that part of the burden of proof which applicants must meet in these proceedings to support a finding that a proposed purchase will be consistent with the public interest is to establish the traffic needs in the territory covered by the rights proposed to be purchased and the nature and scope of the service which has been rendered under those rights. . . . In the instant case, no evidence whatsoever was adduced showing a need for operations under the considered rights. . . . In the absence of evidence showing a need for the additional service by vendee, and where, as here, other carriers have expended their money and energy in developing facilities to handle all available traffic, they are entitled to protection against the establishment of what would be tantamout to a new service in competition with them. To permit a revival of service by vendee under rights presently having no real going-concern value in the considered territory would not foster sound economic conditions among the existing carriers and would not be consistent with the public interest.

In small carrier mergers, interestingly enough, the primary burden of proof seems to rest with the applicant while, in large carrier acquisitions, the burden seems to shift to protestants. In both instances, the position of the small firm is somewhat less than enviable.

Most serious, from the viewpoint of small business, is the Commission's reluctance to consider merger proposals in the light of antitrust criteria.[43] The Commission seems not only to tolerate, but to succor and encourage giant consolidations. Its chairman, in fact, told the Senate Small Business Committee that concentration in the trucking industry should go[44]

> a lot further than it has gone. While there obviously has been a certain amount of concentration, in my personal opinion, there hasn't been enough concentration. We need more concentration than has occurred if we are going to have a healthy, vigorous motor-carrier industry.

And again:[45]

> As I have stated, in our opinion or at least in my opinion, we need more concentration than we have had, so there is no reason to be alarmed about it at this stage of the game. It is like the history of the railroads.

[41] The ICC's "double standard" toward large and small carriers is dramatically illustrated by the Commission's rationale in St. Johnsbury Trucking Co.—Purchase—Hinsch, 59 M.C.C. 419 (1953), 59 M.C.C. 747 (1954); and Law & Ingham—Purchase—Howe (decided July 1, 1955). On a similar set of facts involving the New England area, the Commission reached diametrically opposite decisions. Only after the Senate Small Business Committee hearings exposed the utter inconsistency of the ICC's position did the Commission—at least in this instance—reconsider and reverse its ruling with respect to the small carrier.

[42] Willers, Inc.—Purchase (Portion)—Everson, 10 Fed. Carr. Cas. 222 (1953).

[43] For a comprehensive analysis of this problem, see Fulda, *Antitrust Considerations in Motor Carrier Mergers*, 56 MICH. L. REV. 1237 (1958). See also Schwartz, *Legal Restriction of Competition in the Regulated Industries: An Abdication of Judicial Responsibility*, 67 HARV. L. REV. 436 (1954).

[44] *Hearings, supra* note 18, at 111.

[45] *Id.* at 112.

Perhaps this predilection is a key to the Commission's merger policy. It may explain the Commission's receptivity to ambitious merger programs and its apparent disregard of growing concentration. It may explain the phenomenal success of giants like Pacific Intermountain Express in merger proceedings before the Commission. An examination of section five dockets between 1950 and 1955 shows that the Commission employed vague, vacillating, inconsistent, and sometimes contradictory, standards to sanction PIE's acquisitions.[46] In some cases, the vendors were in financial difficulty, while in others, they could easily have survived as separate entities. In some cases, the merger involved connecting rights, while in others, it covered duplicating rights, and hence resulted in the elimination of some competition. In one case, the Commission approved an acquisition because the resulting routes would be too circuitous to affect the competitive balance in the area.[47] In subsequent proceedings, it allowed PIE to buy rights which reduced, if not eliminated, this circuity.[48] In some cases, the Commission granted its approval on the ground that competitors would not be adversely affected, while in others it simply declared that more intense competition is a good thing. On the one hand, the Commission approved mergers because they would enable PIE to improve its service, while, on the other hand, it assured protestants that their competitive position vis-à-vis PIE would remain undiminished.[49] The rationale of each decision may have been different, but the end result was unmistakable.

This inconsistent treatment of a given carrier at different times, or different carriers at the same time, somehow yields a pattern of favoritism toward large and established regulatees. Behind the façade of administrative expertise, the Commission seems to be able to reach almost predetermined conclusions by subtle variations in the application of regulatory criteria. Inconsistency permits individual commissioners to decide cases more on whim and caprice than on the basis of settled principles. But inconsistency is not only an ICC malaise. It infects other regulatory commissions, in perhaps epidemic proportions, and produces similar effects. Thus, the Federal Communications Commission, according to a content analysis of some sixty television cases—[50]

> appears to have made decisions which are diametrically opposed both to the standards which it itself has developed and to its own decisions in other contemporaneous cases.
> In addition, there has been observed a tendency in the Federal Communications Commission in recent years to modify the weight given to the different criteria developed by it. Such modification has been in the direction of diminishing the importance of criteria such as local ownership, integration of ownership and management, and diversification of control of the media of mass communications (all of which tend to favor the small newcomer, without established broadcasting interests) and magnifying the weight given to the

[46] Adams & Hendry, *supra* note 18, at 261-70.

[47] Pacific Intermountain Express—Control—West Coast Fast Freight, 60 M.C.C. 314 (1955).

[48] Pacific Intermountain Express—Control—Orange (decided Feb. 16, 1956).

[49] Adams & Hendry, *supra* note 18, at 270.

[50] *Excerpts from Report of the House Subcommittee Criticizing the F.C.C.*, N.Y. Times, Jan. 23, 1958, p. 14, col. 4.

criterion of broadcast experience (which tends to favor the large established company, with extensive existing broadcast interests). . . .

In a number of recent cases, indeed, the experience factor has tended to be all but conclusive. The result has been a growing number of decisions which increase the already pronounced tendency toward concentration of ownership in the broadcast field.

The arena may be different, but the issues are the same. Here, as in other regulated industries, small business may solve the technological and economic challenge of the market place. It may even break through the bureaucratic cobwebs of administrative procedure. But how can it penetrate the regulatory mentality which, in the midst of inconsistency, consistently tends to favor entrenched interests.

IV

REGULATORY RESTRICTIONISM AND SUPPRESSION OF COMPETITION

The tendency to favor entrenched interests derives from a protective philosophy—a "going concern" theory of regulation. Faced with a large, powerful, and successful enterprise, a commission is reluctant to tamper with it. To order a drastic change in the affairs of smaller firms seems to offer less of an obstacle—perhaps, because the fear of mistakes is less when the magnitude of the possible error is smaller. Whatever the reason, the very existence of a large, established firm—its presence as a going concern—seems to improve its claim to administrative protection.[51]

This protective philosophy is partly of legislative origin. It is rooted in the statutory authorization for techniques which the antitrust laws proscribe in other industries, viz. the control of prices and the restriction of entry.[52] Prices are made subject to the minimum as well as maximum rate powers of a commission. Entry is restricted through the imposition of certification requirements. Those already in the field are given a preferred position by the grandfather clauses, which assure established firms the right to continue in operation. All other firms must not only convince the regulatory agency that they are fit, willing, and able to render adequate service, but also that such service is required by "public convenience and necessity." In effect, newcomers must show that entry will not make the industry too competitive to maintain rates and profits at a level deemed desirable for the protection of the industry.

Within this broad legislative mandate, the commissions have considerable administrative discretion, and they tend to use such discretion toward protectionist ends. The ICC, for example, has utilized its minimum rate powers "both to protect the railroads from motor carrier competition as well as to safeguard the motor carrier industry from 'destructive' competition within its own ranks."[53] It has used its certification powers to impose an almost insurmountable burden on applicants for

[51] Adams & Hendry, *supra* note 18, at 350.

[52] *Cf.* the excellent statement of John Paul Stevens, a member of the Attorney General's National Committee to Study the Antitrust Laws, before the Senate Small Business Committee, in *Hearings, supra* note 10, at 213-15.

[53] ATT'Y GENERAL'S NAT'L COMM. TO STUDY THE ANTITRUST LAWS, REPORT 265 (1955) [hereinafter cited as ATTORNEY GENERAL'S REPORT].

new operating authority, extension of existing authority, alternate route privileges, and elimination of backhaul restrictions.[54] Repeatedly, the Commission has emphasized that where existing carriers have expended their energy and resources in developing facilities to handle all available traffic, and where their service is adequate, they are entitled to protection against the establishment of a new, competitive operation. In some cases, the Commission has even espoused the doctrine that adequate rail service is sufficient ground for denying the inauguration of a competing truck service.[55] Most pernicious, however, is the Commission's theory that shipper need is to be measured in physical rather than economic terms—*i.e.*, as long as existing carriers are physically capable of performing a given service, prospective competitors are to be denied entry—even if their service is cheaper, better, and more efficient.[56] The implications of this for small business are too obvious for comment.

The Civil Aeronautics Board, at least until recently, has followed a similarly restrictive and protective policy. Despite a 4,000 per cent increase in air travel between 1938 and 1956, the Board has not allowed a single new passenger trunk line carrier to enter the industry. According to a former CAB chairman,[57]

> In every instance thus far in which the Board has found that additional and competing passenger trunkline services on high density segments are required by the public convenience and necessity it has concluded that the objectives of the act would be better served by the award of the route to a carrier already holding certificate authority than to a new company.

According to Judge Rizley, this restrictive entry policy reflects an "undue shift of emphasis from public convenience and necessity to the seeking and protection of private carrier rights."[58] It explains, in part, why eighteen years after regulation was instituted, the grandfather carriers still earn roughly ninety per cent of all commercial revenues in the industry.[59]

Symptomatic of the Board's solicitude for established regulatees is its policy toward the nonscheduled airlines. The "nonskeds" were denied entry into the industry because the Board feared the probable diversion of traffic from established carriers, the effect of such diversion on existing load factors, and the subsequent subsidy drain on the federal treasury.[60] The fact that these fears were largely unfounded; that irregular competition provided a yardstick for measuring the possibilities of profitable, unsubsidized service; that such yardstick competition could be an adjunct to conventional regulatory controls; that the "nonskeds" offered promo-

[54] *Cf.* Select Committee on Small Business of the Senate, *Competition, Regulation, and the Public Interest in the Motor Carrier Industry*, S. REP. No. 1693, 84th Cong., 2d Sess. 2-14 (1956).

[55] This is the testimony of the Chief of the Antitrust Division, Dep't of Justice, in *Hearings, supra* note 10, at 138-39.

[56] *Id.* at 186-88.

[57] Quoted in Antitrust Subcommittee of the House Committee on the Judiciary, *The Airlines Industry*, H.R. REP. No. 1328, 85th Cong., 1st Sess. 102-03 (1958) [hereinafter cited as REPORT ON AIRLINES].

[58] Address by Ross Rizley, *supra* note 31.

[59] REPORT ON AIRLINES 74.

[60] Transcontinental Coach-Type Service Case, 14 C.A.B. 720 (1951).

tional competition which tapped formerly untapped markets rather than diverted traffic from the certificated carriers; in short, that the "skimming of the cream" complaint against the "nonskeds" had little substance is only further evidence of protective restrictionism.[61] It reflects an administrative milieu hostile to entry and competition—a milieu in which there is little place for the enterprising, innovating, small business newcomer. Incidentally, it also reflects a scheme of values where protection of the regulatee takes precedence over promotion of the public interest.[62]

This regulatory protectionism has other ramifications. In some cases, it implies not only a restrictive entry policy, a toleration of price-fixing arrangements, and a promotion of mergers, but also administrative efforts to suppress the competition of unregulated substitutes. "The temptation," as Lucille Keyes observes,[63]

> is to make the path of the regulative agency easy; to eliminate the uncertainties arising from outside competition by empowering these agencies to suppress it; and thus also to soothe the feelings of possibly outraged regulatees who may complain of having to serve two masters: the commission and the competitive market.

Regulation is contagious. Its logical consequence is the systematic suppression of outside competition—or, at least, the constant harassment of unregulated, irregular, exempt, or unlicensed interlopers.[64]

The administrative decisions and legislative recommendation of the ICC illustrate this proposition. The Commission fought for the Motor Carrier Act of 1935 in order to protect railroads from the unregulated competition of the trucking industry.[65] It supported the Transportation Act of 1940[66] to protect the railroads from

[61] Adams, *The Role of Competition in the Regulated Industries*, 48 AM. ECON. REV. PROC. 527, 539-40 (1958).

[62] Professor Marver Bernstein has observed that regulation by independent commissions "tends to destroy rather than promote competition. The historical tradition of commissions is anticompetitive. Their basic methods, especially their reliance upon the case-by-case approach, place small-business firms at a disadvantage. The growing passivity of the commissions' approach to regulation and the inconvenience of dealing with large numbers of firms strengthen the commissions' tendency to identify their view of the public interest with the position of the dominant regulated firms. In short, regulation of particular businesses by independent commission stacks the cards against the small competitive firm and weakens the force of competition." *Hearings on Monopoly Problems in Regulated Industries, Airlines, Before the Antitrust Subcommittee of the Committee on the Judiciary of the House*, 84th Cong., 2d Sess. 64 (1956).

[63] Keyes, *The Protective Functions of Commission Regulation*, 48 AM. ECON. REV. PROC. 544, 546 (1958).

[64] The nonscheduled airlines, according to the Senate Small Business Committee, "have managed to survive since 1948 in spite of constant harassment: The CAB's ever-narrowing interpretation of its regulations; new regulations designed to limit the 'nonskeds' almost entirely to noncommon carrier operations; vigorous enforcement activities and regulatory actions which will, if unchecked, inevitably eliminate them within a year or two; and a campaign possibly inspired by major airlines to discredit them in the public mind." Select Committee on Small Business of the Senate, *Role of Irregular Airlines in United States Air Transportation Industry*, S. REP. No. 540, 82d Cong., 1st Sess. 5 (1951). The Committee's prediction on the demise of the "nonskeds" came true—at least with respect to North American Airlines, the most powerful carrier group in the "nonsked" category.

[65] The Motor Carrier Act was the culmination of a determined legislative campaign by the railroads and the ICC (which acted as their spokesman) to stifle unregulated competition. In its annual report for 1932, the Commission conceded that "there is substantially no demand for public regulation of the charges of motor trucks to protect shippers against exorbitant or discriminatory charges. The demand has been chiefly from the railroads, and for the prescription of minimum rather than maximum charges." 46 ICC ANN. REP. 20 (1932). Despite this admission, and despite the strong opposition of the major

the unregulated inland water carriers.[67] It pleaded with Congress to "clarify" the status of private and contract motor carriers in order to shield certificated firms from troublesome rivals. Most dramatically, it sought to narrow and emasculate the agricultural exemption under which motor vehicles hauling ordinary livestock, fish, or agricultural commodities (not manufactured products thereof) were exempt from the entry, rate, and route restrictions of the ICC.[68]

In attacking the agricultural exemption, the Commission at first proclaimed the "poisoned vehicle" doctrine, which made the vehicle, not the commodity, the test for the exemption.[69] Next, the Commission embraced the "channels of commerce" theory, which held that the exemption covers only the first haul from farm to market.[70] Then, the Commission announced a number of restrictive commodity interpretations under which redried tobacco leaf, dressed poultry, shelled nuts, nursery stock, flowers and bulbs, and frozen fruits and vegetables were held to be manufactured goods, rather than agricultural commodities.[71] Finally, the Commission adopted a "trip leasing" regulation, which would have nullified the exemption for agricultural haulers who used single-trip or backhaul leases to achieve full utilization of equipment and consequent economy of operation.[72] These attempts to cur-

farm organizations and most shipper groups, the ICC consistently endorsed legislation to bring unregulated segments of the transportation industry under its control. See Huntington, *The Marasmus of the ICC: The Commission, the Railroads, and the Public Interest*, 61 YALE L. J. 467, 478-81 (1952); see also REPORT ON AIRLINES 265.

[66] 54 STAT. 950 (1940), 49 U.S.C § 153 (1952).

[67] Here, as in the case of motor carrier regulation, the farm organizations, the shippers, and the majority of the water carriers themselves were strongly opposed to regulation. The ICC, the Federal Coordinator of Transportation, and the railroads were strongly in favor of regulation. See Huntington, *supra* note 65, at 479.

[68] Interstate Commerce Act II, § 203(6)(b), 52 STAT. 1029 (1938), as amended, 66 STAT. 479, 49 U.S.C. § 303(b) (1952).

[69] Monark Egg Corp. Contract Carrier Application, 26 M.C.C. 615 (1940); Norman E. Harwood Contract Carrier Application, 47 M.C.C. 597 (1947). The "poisoned vehicle" doctrine was struck down by the courts in ICC v. Dunn, 166 F.2d 116 (5th Cir. 1948); ICC v. Service Trucking Co., 91 F. Supp. 533 (E.D. Pa. 1950), *aff'd*, 186 F.2d 400 (3d Cir. 1951).

[70] Monark Egg Corp. Contract Carrier Application, 44 M.C.C. 15 (1944). Seven years later, the Commission itself rejected the "channels of commerce" theory in Determination of Exempted Agricultural Commodities, 52 M.C.C. 511 (1951).

[71] Determination of Exempted Agricultural Commodities, 52 M.C.C. 511 (1951); ICC v. Yeary Transfer Co., 104 F. Supp. 245 (E.D. Ky. 1952), *aff'd*, 202 F. 2d 151 (6th Cir. 1953); ICC v. Kroblin, 113 F. Supp. 599 (N.D. Iowa 1953), *aff'd*, 212 F.2d 555 (8th Cir. 1954), *cert. denied*, 348 U.S. 836 (1954); East Texas Motor Freight Lines v. Frozen Food Express, 351 U.S. 49 (1956); Consolidated Truck Service v. United States, 144 F. Supp. 814 (D. N.J. 1956); Florida Gladiolus Growers Ass'n v. United States, 106 F. Supp. 525 (S.D. Fla. 1952); Home Transfer & Storage Co. v. United States, 141 F. Supp. 599 (W.D. Wash. 1956), *aff'd*, 352 U.S. 884 (1956).

[72] *Ex parte* MC-43, Lease and Interchange of Vehicles by Motor Carriers, 52 M.C.C. 675 (1951). Perhaps the Commission's reason for adopting a rule so destructive of the agricultural exemption is best revealed in a colloquy which took place in the district court in American Trucking Ass'n v. United States, 344 U.S. 298 (1953). The attorney for the Commission was asked if it was wasteful for a truck to bring an exempt load from Florida to the north and then return empty, to which he replied—with commendable candor: "It does seem uneconomical in requiring it to go back empty but they can. The difficulty comes, I think, in letting it come up in the first place." Quoted in minority opinion, *id.* at 332. For a discussion of the implications of this order, see *Hearings*, *supra* note 10, at 116-18, 124, 108-09; 252-53; 53-54; 177-82.

tail unregulated competition were consistently defeated—both in the courts and in Congress. According to Judge Graven,[73]

> There are two features that stand out most predominantly in the voluminous legislative history relating to amendments made or proposed to Section 203(b)(6). One feature is that every amendment that Congress has made to it has broadened and liberalized its provisions in favor of exemption and the other feature is that although often importuned to do so, Congress has uniformly and steadfastly refused or rejected amendments which would either directly or indirectly have denied the benefits of the exemptions. . . .

The Transportation Act of 1958,[74] however, reversed this unidirectional trend. In response to persistent ICC requests, Congress subjected to regulation a number of agricultural commodities theretofore considered exempt.[75] In addition, Congress responded to industry and ICC pressures to narrow the exemption of private carriers[76] and the scope of contract carriers.[77] Regulation was tightened with respect to competitive elements within the industry and extended to previously unregulated

[73] ICC v. Kroblin, 113 F. Supp. 599, 630-31 (N.D. Iowa 1953). For an analysis of the legislative and judicial history of the agricultural exemption, see also Fulda, *The Agricultural Exemption in the Motor Carrier Act Should Not Be Repealed,* 43 VA. L. REV. 677 (1957); Fulda, *Competition Versus Regulation: The Agricultural Exemption in the Motor Carrier Act,* 11 VAND. L. REV. 543 (1948); U.S. DEP'T OF AGRICULTURE, THE AGRICULTURAL EXEMPTION IN INTERSTATE TRUCKING (Marketing Research Rep. No. 118, 1957).

[74] § 7(a), 72 STAT. 573, 49 U.S.C.A. § 303 (Supp. 1959).

[75] Frozen fruits, frozen berries, and frozen vegetables were specifically removed from the exempt category. Not content with this partial victory, however, the certificated carriers are now demanding similar action with respect to fresh and frozen dressed poultry, shelled peanuts, frozen milk and cream, and powdered milk. According to the railroads, "continuation of such processed or manufactured commodities in a special status exempt from regulation clearly is of no provable significant benefit to farmers, while the effect on regulated carriers, whose rates must be published and cannot readily be adjusted to meet the rates of their unregulated competitors, can only be detrimental. Failure of Congress to roll back the scope of the exemption to its original and only justifiable purpose [the initial movement from farm to market] leaves still another major transportation problem unresolved." AMERICAN ASSOCIATION OF RAILROADS, TRANSPORT TALLY 11-12 (1958). Here, once again, is an admission that the certificated carriers, especially the railroads, cannot fight unregulated substitutes by economic measures and that they need protective legislation to hold their own in the transportation market. Ironically enough, these carriers demand protection from competition, while at the same time claiming competitive superiority. Apparently, they intend to demonstrate this superiority through the legislative extinction of their "inferior" rivals. Until this happens, however, the exempt carriers shall continue to furnish embarrassing proof that competition in trucking makes for better, cheaper, and more efficient service. See, *e.g.,* U.S. DEP'T OF AGRICULTURE, INTERSTATE TRUCKING OF FRESH AND FROZEN POULTRY UNDER AGRICULTURAL EXEMPTION (Marketing Research Rep. No. 224, 1958).

[76] Under the Transportation Act of 1958, § 8(c), 72 STAT. 574, 49 U.S.C.A. § 303(c) (Supp. 1959), no person engaged in any business enterprise other than for-hire transportation shall "transport property by motor vehicle in interstate or foreign commerce for business purposes unless such transportation is within the scope, and in furtherance, of a primary business enterprise (other than transportation) of such person." According to its sponsors, this provision is designed to stop the practice of buying and taking title to goods in one location to sell them at a price, including a charge for transportation, at another location.

[77] Under a 1958 amendment to the Interstate Commerce Act, contract carriage by motor vehicle is limited to for-hire transportation performed under contract for *one* person or a *limited* number of persons, under terms and limitations laid down by the ICC. 72 STAT. 573 (1958), 49 U.S.C.A. § 303(a)(15) (Supp. 1959). Previously, contract carriers were free, within the scope of their authority, to serve *any* number of shippers. Another amendment requires contract carriers to file with the Commission their actual, rather than minimum, rates or charges. 71 STAT. 343 (1957), 49 U.S.C.A. § 318(a) (Supp. 1959). The purpose, according to the railroads, was to limit the freedom of contract carriers "to undercut the rates of common carriers at will." ASSOCIATION OF AMERICAN RAILROADS, *op. cit. supra* note 75, at 19.

substitutes. Once again, it was demonstrated that regulation breeds regulation, that it cannot tolerate competition from within or without, and that vested interests—once they have been established—will insist on the protection and extension of their privileges.

In a sense, this is inevitable. Once a commission is given the power to dispense private privilege, it is almost compelled to validate the financial values predicated on such privilege, and does so by suppressing competition wherever possible. The only escape from this dilemma is to abolish the power of privilege and, where economically and technologically feasible, to place greater reliance on the regulatory machinery of competition. This is the only defense which small business has against treatment as an economic interloper and outlaw.

V

UNDUE IDENTIFICATION BETWEEN REGULATORS AND REGULATEES

One other factor may explain the discrimination, restrictionism, and protectionism so frequently associated with regulation. This is the tendency of many commissioners to identify so closely with the industries they regulate, that the "regulatees wind up doing the regulating."[78] In its mildest form, such identification results in subordination of the public interest to private privilege; in its most virulent form, it results in influence peddling and corruption.

The average commissioner is not immune from human frailty and ambition. Appointed for only a limited term of office, he is concerned with his future. Whether he plans to remain in government service or to enter private practice, his career depends, in large measure, on the industry he is supposed to regulate. If he wants to be reappointed by the President and confirmed by the Senate, the industry's support is an undeniable, and perhaps decisive, asset. If he is not reappointed or if he decides to retire, his professional future lies almost certainly with the industry. In any event, the commissioner is aware of the experience of his predecessors. He knows that the industry's enemies seldom go unpunished, and that mavericks and nonconformists must seek other than tangible rewards.[79] And so, quite naturally and perhaps imperceptibly, an accommodation of views takes place.

[78] Remark attributed to Senator Burton K. Wheeler, and quoted in BLAIR BOLLES, HOW TO GET RICH IN WASHINGTON 23 (1952). After its investigation of the airline industry, the Senate Small Business Committee found "reasonable grounds for concluding that there exists a certain identity of interest between the CAB and the more firmly established portion of the industry. Such identity of interest is not infrequent between Government regulatory bodies and those subject to their regulation." Select Committee on Small Business of the Senate, *Role of Irregular Airlines in United States Air Transportation Industry*, S. REP. No. 540, 82d Cong., 1st Sess. 2 (1951).

[79] Some commissioners are unquestionably able and dedicated men, but ability and devotion are no guarantee of personal success. A commissioner who unswervingly defends the public interest and enforces the law without fear or favor takes a calculated risk. He must be prepared for the consquences—a possibly abrupt end to his official career. James M. Landis, for example, a CAB chairman and noted jurist, was denied reappointment for opposing the merger of Pan American with American Overseas Airlines. Leland Olds, an FPC chairman, who had spent a lifetime promoting natural gas conservation, was denied Senate confirmation because his opinions were unpalatable to powerful natural gas interests and their protagonists in Congress. CAB Commissioner Joseph Adams, an able and devoted public servant, was not reappointed because he was so indiscreet as to support a more competitive certification

This accommodation of views is facilitated by the informal and nonjudicial atmosphere surrounding the relation between the regulated and their regulators.[80] Some commissioners engage in constant fraternization with individuals and corporations who appear as litigants before their agency. Some have had their room, board, and other expenses paid by the regulated industry while attending industry conventions.[81] Some have had *ex parte*, off-the-public-record discussions with litigants about pending cases and have, at least in some instances, referred to the merits of these cases.[82] Members of the FCC have received free service contracts for their personal television, radio, and hi-fi sets from a company which is no stranger to litigation before the commission.[83] One FCC commissioner has been indicted for allegedly accepting a bribe in the award of a Miami television channel, and a former FCC chairman has not found it improper to be approached by various parties in a Boston television case. These men, he reported to a congressional committee, did not want to influence him or do anything wrong; they just wanted to tell him what fine fellows they were.[84]

This is not the kind of milieu which inspires confidence in quasi-judicial decision-making. If a federal judge engaged in the foregoing practices, he would be consid-

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policy and the allocation of routes to "have not" carriers. Other commissioners, by contrast, with more ambivalent records and more sympathetic understanding of their regulatees, have found the going easy. Their reappointment and confirmation were seldom debated, and their economic future upon separation from government service was rarely in doubt. Thus, Owen D. Clarke, an ICC chairman and articulate spokesman for the certificated giants, resigned to accept the vice-presidency of the C & O Railroad. His ICC colleague, Robert W. Minor, turned down a seven-year reappointment to become vice-president of the New York Central Railroad. In these, as in other cases, there is some question whether the personnel of regulatory commissions look upon their positions as a public trust or merely as a convenient stepping stone to lucrative employment in the industry they are supposed to regulate.

[80] Most commissions have formulated principles of practice designed to preserve a judicial atmosphere. The CAB's rules, for example, state: "300.2 *Hearing Cases—Improper Influence.* It is essential in cases to be determined after notice and hearing and upon a record that the Board's judicial character be recognized and protected. In such cases—

(a) It is improper that there be any private communication on the merits of the case to a member of the Board or its staff or to the examiner in the case by any person, either in private or public life, unless provided for by law.

(b) It is likewise improper that there be any private communications on the merits of the case to a member of the Board or to the examiner in the case by any members of the Board's staff who participate in the hearing as witnesses or as counsel.

(c) It is improper that there be any effort by any person interested in the case to sway the judgment of the Board by attempting to bring pressure or influence to bear upon the members of the Board or its staff, or that such person or any member of the Board's staff, directly or indirectly, give statements to the press or radio, by paid advertisements or otherwise, designed to influence the Board's judgment in the case." 14 C.F.R. § 300.2 (1956).

[81] *Excerpts from Report of the House Subcommittee Staff Criticizing the F.C.C.*, N.Y. Times, Jan. 23, 1958, p. 14, col. 1.

[82] The Subcommittee on Legislative Oversight found that in the *Miami Channel 10* case "several ex parte contacts on behalf of two of the principal contenders for the license were made or attempted to be made both by persons who did, and by persons who did not, participate in the presentation or preparation for presentation of the case before the examiner." Special Subcommittee on Legislative Oversight of the House, *Interim Report on the Federal Communications Commission*, H.R. REP. No. 1602, 85th Cong., 2d Sess. 16 (1958). In the airline industry, the famous Denny-Tipton conversation has raised similar questions of improper influence. See REPORT ON AIRLINES 147-59, esp. 149 and 157.

[83] *Excerpts from Report of the House Subcommittee Staff Criticizing the F.C.C.*, N.Y. Times, Jan. 23, 1958, p. 14, col. 1.

[84] 104 CONG. REC. 7253 (daily ed. May 6, 1958).

ered unfit to continue in office. For a judge to accept favors from a litigant would be a gross violation of judicial ethics; and for a litigant to offer such favors, a grave impropriety. It is inconceivable that a judge would permit the parties in a pending case to come in and tell him what fine fellows they are. Such *ex parte* relationships are not only improper, but they offend a basic canon of American administrative law, viz. "the exclusiveness of the record." They do violence to a decision-making process based entirely on evidence presented in open hearings and contained in a public record.[85]

For small business, the implications are far from sanguine. The small firm must keep its nose to the grindstone. It must fight the daily vicissitudes of the market place to assure survival. It has neither the resources nor the public-relations machinery to exercise proper or improper influence. Regardless of its moral inclinations, it cannot compete for the minds and souls of individual commissioners. It cannot offer lucrative jobs, nor can it guarantee effective political support. It can only hope for the appointment of commissioners who have the wisdom, integrity, devotion, and perseverance to resist the fleshpots of temptation. But hope, in this context, is not always an effective weapon.

CONCLUSION

Regulation by independent regulatory commissions has not turned out to be the new, flexible, creative control instrument envisaged by the philosophers of the administrative process. Even in the absence of venality and corruption, regulation has come to suffer from deep-seated institutional infirmities which militate against the competitive entrepreneur and dynamic innovator. The cost and delay of proceedings; the harassment by powerful protestants; the slavish adherence to technicalities; the pharasaical devotion to a case-by-case approach; the sacrifice of substance for form; the use of differential, inconsistent, and often discriminatory standards; the adoption of restrictive and protective policies; the undue identification with established interests; the petulant defense of the status quo; the sensitivity to organized pressures; the pervasive distrust of large numbers—these have become the hallmark of the regulatory process. Lacking boldness of vision, and beset by an anti-competitive bias, a bureaucratic rigidity, and an annoyance with the forces of change, the commissions have generally been hostile to the newcomer, the challenger, the innovator. As a result, the regulated industries have not been a favorable habitat for small business.

This problem, while vexing, is not insoluble. A reappraisal of the regulatory experiment in the light of experience may well indicate that (1) in inherently com-

[85] To prevent such *ex parte* relationships, the Subcommittee on Legislative Oversight has recommended legislation ". . . (2) to require that any Commissioner or staff member receiving an ex parte communication shall place such communication (or a memorandum stating the circumstances and substance of such communication if such communication was made orally) in the public record in the case; and (3) to provide that the Secretary of the Commission shall transmit to each party a copy of such communication or memorandum." Special Subcommittee on Legislative Oversight of the House, *supra* note 82, at 17.

petitive industries, where there are no substantial economies of scale, gradual but total deregulation is both feasible and desirable;[86] (2) in industries where some regulation is necessary, the commissions should be compelled by specific mandate "to promote competition and diversification to the maximum extent practicable";[87] in some of these industries, commissions should be directed to approve entry applications, except where such approval can be shown to be contrary to the public interest—*i.e.*, the presumption should be in favor of entry, and the burden of proof, in case of denial, should be on the commissions, not the applicant;[88] and finally (3) in industries where some regulation is necessary, combinations and collusive practices should not be immune from antitrust attack, unless the commissions can show that

[86] The trucking industry, for example, possesses none of the "natural monopoly" characteristics normally associated with such public utilities as local gas, water, and light companies. In fact, recent trucking studies cast serious doubt on the correlation between giant firm size and operating efficiency. Other factors than size seem to be more directly related to adequate service at low cost. The alleged economies of scale are apparently no more than the figment in a bureaucratic imagination. See Roberts, *Some Aspects of Motor Carrier Costs: Firm Size, Efficiency, and Financial Health,* 32 LAND ECON. 228 (1956); NEW ENGLAND GOVERNORS' COMMITTEE ON PUBLIC TRANSPORTATION, MOTOR FREIGHT TRANSPORT FOR NEW ENGLAND: A REPORT TO THE NEW ENGLAND GOVERNORS' CONFERENCE (Rep. No. 5, 1956); Pegrum, *The Economic Basis of Public Policy for Motor Transport,* 28 LAND ECON. 244 (1952); and "Statement by Professor Dudley F. Pegrum, Professor of Economics, University of California, Los Angeles, to the Senate Small Business Committee on the Effects of Regulation on Small Business," in *Hearings, supra* note 10, at 465.

[87] In the airline industry, the regulatory mandate in Civil Aeronautics Act § 2(d), 52 STAT. 980 (1938), 49 U.S.C. § 402(d) (1952), calls for the promotion of competition only "to the extent necessary to assure the sound development of air transportation." The Celler Committee, after a rather thorough investigation of the industry, recommended that Congress direct the CAB to consider competition "to the maximum extent practicable," rather than "to the extent necessary." This shift of emphasis, the Committee said, "would tend to overcome the protectionist bias" in airline regulation. See REPORT ON AIRLINES 267. Other observers have found that the industry's technological and economic characteristics do not justify the CAB's pervasive entry restrictions. *E.g.*, LUCILLE S. KEYES, FEDERAL CONTROL OF ENTRY INTO AIR TRANSPORTATION (1951); Maclay & Burt, *Entry of New Carriers into Domestic Trunkline Air Transportation,* 22 J. AIR L. & COM. 131 (1955). Lucille Keyes has suggested that Congress "promptly provide for the abolition of entry control geared to the protection of carrier revenues." She feels that "this aim can be most satisfactorily accomplished through a Congressional policy declaration affecting the working criteria of the regulatory agency rather than through outright rescission of the certification requirement itself." Keyes, *A Reconsideration of Federal Control of Entry into Air Transportation,* 22 J. AIR L. & COM. 192, 201-02 (1955). Also noteworthy in this connection are the following conclusions of the Brownell Committee: "All other factors being equal, the policy of the antitrust laws would clearly favor competition by two to service by one. If, therefore, the statutory standard of 'public interest' gives any effect at all to antitrust policy, in a case in which all other factors neutralize one another, it should require a regulatory agency to resolve such an issue in favor of competition rather than monopoly." ATTORNEY GENERAL'S REPORT 267. "Even in areas where Congress has adopted the policy that 'competition may [not] have full play, we feel that unless Congress has expressly provided to the contrary, the regulatory guide consistent with the 'public interest' . . . must 'include the principles of free enterprise which have long distinguished our economy.' It is no longer subject to challenge that 'competition is a relevant factor in weighing the public interest.'" *Id.* at 269.

[88] The Senate Small Business Committee has recommended that the Interstate Commerce Act § 307, 49 STAT. 551 (1935), 49 U.S.C. § 307 (1952), be amended to direct the ICC to issue motor carrier certificates "if it is found that the applicant is fit, willing, and able properly to perform the service proposed . . . and unless there is clear and convincing evidence that the proposed service . . is not or will not be required by the present or future public convenience and necessity." Select Committee on Small Business of the Senate, *Competition, Regulation, and the Public Interest in the Motor Carrier Industry,* S. REP. No. 1693, 84th Cong., 2d Sess. 28 (1956). The Committee suggested a similar change with respect to the permit requirements governing contract carriers. *Ibid.* It is significant that even Secretary of Commerce Sinclair Weeks, a persistent spokesman for regulatory restrictionism, endorsed this suggested change. See *Hearings, supra* note 10, at 310.

in particular cases, a specific exemption would yield affirmative benefits to the public.[89] Of course, these proposals cannot be applied across the board and must be adapted to the technological and economic peculiarities of individual industries. They do point, however, to a reorientation of regulatory policy toward expansionary instead of restrictionist goals. They imply acceptance of competition as a basic, though rebuttable, presumption underlying the regulatory mechanism. For small business, they mean not special privileges or class legislation, but genuine equality of opportunity.

[89] Implementation of this recommendation would imply, for example, repeal of the Reed-Bulwinkle Act, 62 STAT. 472 (1948), 49 U.S.C. § 5b (1952), and a resolution of the "primary jurisdiction" problem. On the latter issue, see ATTORNEY GENERAL'S REPORT 278-87.

SOME COMPETITIVE PRACTICES WITH WHICH SMALL BUSINESS MUST CONTEND

Albert A. Carretta*

The Small Business Act,[1] approved by the President on July 18, 1958, defines a small business concern as "one which is independently owned and operated and which is not dominant in its field of operation."[2] This is a rather broad definition, but it appears adequate for purposes of the present paper. The Small Business Act also recites a statement of policy which should warm the hearts of those who fear the current trend to bigness. Included in this statement is the following language:[3]

> It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise. . . .

As of December 31, 1957, there were in existence in the United States 4,322,700 business firms, excepting those engaged in professional services and agriculture.[4] The breakdown of these firms was this:

Construction	486,700
Manufacturing	308,600
Wholesale	302,000
Retail trade	1,878,900
Service industries	768,100
All other business	578,400
	4,322,700

Of all these business concerns, almost forty-four per cent were engaged in the retail trade. Consequently, it can reasonably be assumed that any competitive practice which affects the retail trade also affects a substantial percentage of the total business firms in the United States (excepting, again, those engaged in professional services and agriculture).

If the retailers were asked to name their most pressing business problem today, their general answer would be "discount houses." For about a quarter of a century, there has been a slow but continuous growth in the number of retail outlets which have attracted the consumers' dollars through use of the word "discount." Although the practice of price-cutting employed by such outlets is by no means new, the

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[1] 72 Stat. 384 (1958), 15 U.S.C.A. §§ 631 *et seq.* (Supp. 1959).

[2] *Id.* § 632.

[3] *Id.* § 631(a).

[4] Survey of Current Business, Aug. 1958, p. 4.

apparent recent growth in sales made by discount houses is beginning to cause their competitors to "sit up and take notice." Yet, obviously, this concern with the problem of discount houses will not, without further action, increase the number of sales recorded on the cash registers of the millions of independent retailers throughout the United States.

Too many Americans, both in the ranks of management and of distribution, make the error of looking upon the present period of intense and sometimes unscrupulous competition as being only a temporary condition. They plan to wait patiently until the "temporary condition" has righted itself. However, the adoption of such a plan by independent retailers plagued with the competition of discount houses can only lead to business failures.

To discuss this special problem that faces the retail distributors, it will be necessary to define certain terms so as properly to limit the application of the conclusions reached.

"Retailers" generally are considered to be merchants who buy articles in large quantities and who sell such articles in small quantities, usually to ultimate consumers. But since such a definition would include discount houses, it will have to be qualified. As used herein, "retailers" are only those merchants who do business in the so-called "fair trade" states, and who buy articles in large quantities and sell such articles in small quantities at or above the stipulated or minimum prices set by the manufacturers in fair trade agreements. Such a definition, of course, excludes discount houses. For convenience, those falling within this definition will also sometimes be referred to as "conventional retailers" or "ethical retailers."

"Fair trade" is more often than not misunderstood. As used herein, the term "fair trade" shall refer to the method of merchandising originally legalized by the statutes enacted in forty-five states of the United States,[5] commonly referred to as fair trade statutes. The Miller-Tydings Act of 1937[6] and the McGuire Act of 1952[7] exempted fair trade contracts from the prohibitions of the Sherman Antitrust Act[8] and the Federal Trade Commission Act.[9]

These state laws generally permit, but they do not compel, a manufacturer of certain goods identified by a trade-mark, brand, or name to guard the property value of such trade-mark, brand, or name by permitting him to set the minimum prices at which such products may be resold. They generally provide that the minimum resale price provision of fair trade contracts shall be binding not only upon all distributors who sign such contracts, but also upon all other distributors of the same products who have knowledge of the existence of a fair trade contract between a manufacturer and a distributor covering the same products identified by a trade-mark, brand, or name. No retailer or distributor is required to carry and offer for

[5] CCH TRADE REG. REP. ¶ 3075 (10th ed. 1956).
[6] 50 STAT. 693, 15 U.S.C. §§ 1 *et seq.* (1952).
[7] 66 STAT. 632, 15 U.S.C. §§ 45 *et seq.* (1952).
[8] 26 STAT. 209 (1890), 15 U.S.C. §§ 1-7 (1952).
[9] 38 STAT. 717 (1914), 15 U.S.C. §§ 41 *et seq.* (1952).

sale any fair-traded product. But if a retailer does, and he either enters into a fair trade contract with the manufacturer, or knows of the existence of such a contract, then he must respect the minimum resale price provision of such contract.

The state fair trade statutes should not be confused with any of the unfair practices acts adopted by many of the states; or with any of the state anti-price discrimination acts; or with the Robinson-Patman Act;[10] or with any other antitrust legislation of either the federal government or of the state governments.

"Discount houses" could very simply be defined as "price-cutters." But not all price-cutters are intended to be covered herein. "Discount houses" have been defined as retail distributors who sell merchandise at a discount from the manufacturer's listed retail price or from the price at which other types of retailers sell the same merchandise. This definition, however, is too broad for the purposes of this article. Because of the current controversy over the economic wisdom of fair trade statutes, the term "discount houses" as used herein shall apply only to those retail distributors located in a fair trade state who sell articles at prices below the minimum resale prices legally fixed by the manufacturers thereof in a fair trade agreement of which the retail distributors have knowledge. It can readily be seen that this definition excludes the ordinary price-cutters, who have no obligation to maintain prices. This definition also excludes those retail distributors who cut price on articles which are not fair-traded by the manufacturers, but which carry only "suggested" resale prices.

The consuming public has been told over and over again that fair trade means fixed prices at high levels. Many consumers have believed this assertion because at the same time it was being made by discount house operators, these same operators were offering the public fair-traded items at less than the minimum resale prices fixed by the manufacturers of those items. Why then did at least a majority of the legislatures of forty-five states vote for fairly uniform state fair trade statutes? Why then did approximately ninety-one per cent of the congressmen voting at the time favor the enactment of the McGuire Act?

I

PURPOSES OF FAIR TRADE LEGISLATION

Remembering the old maxim that "there is a little bit of good in every bad little boy," let us examine a typical fair trade law to determine if it has any good points. First and foremost, these statutes generally provide that resale price maintenance agreements may be entered into only with respect to commodities which bear the trade-mark, brand, or name of the producer of such commodity. Thus, resale price maintenance agreements would seem illegal when entered into with respect to any commodity which does not bear the trade-mark, brand, or name of its producer. Obviously, the aim of the statutes was to protect the property—namely, the good will—of the producer; and the price restriction provision was adopted as an appropri-

[10] 49 STAT. 1527 (1936), 15 U.S.C. §§ 13-13c, 21a (1952).

ate means to that perfectly legitimate end, and not as an end in itself. Such was the opinion of a unanimous Supreme Court in December 1936.[11]

Quite frequently, because of the quality of his product or the waging of an extensive advertising campaign, a manufacturer's trade-name become valuable to retailers who distribute his product. Even when the product of other manufacturers is almost equally good, the trade name may assure to the retailer a ready market for the product. Now, if the manufacturer sold his product directly to the ultimate consumer, there would be no question of his right and ability to control the price at which the product would reach the public. If, however, instead of selling directly to the ultimate user, the manufacturer decided, perhaps long ago, to use retail outlets as his distributors, the situation is somewhat different.

Undeniably, when a retail outlet purchases the product, title thereto passes to the retailer. But the retail distributor is dealing not with a commodity alone, but with a commodity *plus* the brand-name which it carries as evidence of its origin and the quality for which the brand-name stands. Despite the ownership he may acquire of the product, the retailer cannot acquire ownership of the trade-name or the good will which it symbolizes. As the Supreme Court has put it:[12]

> The ownership of the good will, we repeat, remains unchanged, notwithstanding the commodity has been parted with.

If a retailer who desired to sell below the manufacturer's nationally advertised price were willing to remove the trade-name from the product and to neither state nor imply that they were the same as the nationally advertised goods, then the retailer would seem clearly entitled to sell at whatever price he pleased. However, discount houses are totally unwilling to market a popular product in this manner. And so they run afoul of the Supreme Court's pronouncement:[13] "Ownership of the goods does not carry the right to sell them with a specific mark." The fair trade laws give effect to this view.

Fair trade laws generally provide that, to be the subject of a permissible resale price maintenance agreement, a commodity must be "in free and open competition with commodities of the same general class produced or distributed by others." This is a basic antimonopoly provision contained in state fair trade statutes, in the Miller-Tydings Act, and in the McGuire Act, and it is important because it prevents gouging of the consuming public and the fixing of fair trade prices at high levels. The prices of commodities sold in free and open competition with other commodities of the same general class will always be subject to the powerful forces of competitive bids and offers. If the manufacturer of a trade-marked product which is fair-traded should market his product at a price that the consumer deems too high, then the consumer will naturally purchase a commodity of the same general class which is produced by another manufacturer who does fair-trade his product at a

[11] Old Dearborn Distributing Co. v. Seagram Distillers Corp., 299 U.S. 183 (1936).
[12] *Id.* at 195.
[13] Bourjois & Co. v. Katzel, 260 U.S. 689, 692 (1923).

lower price. Moreover, it should be remembered that a manufacturer establishes his fair trade price at his own peril—especially the peril that if he sets it too high, either the consumer will not buy the product or, should the article remain popular nonetheless, the high profits will invite even more competition from other manufacturers. If trade-marked products which are subject to resale price maintenance agreements actually are in free and open competition with commodities of the same general class produced by others, then in due course, any fixed resale prices with too much "fat" will eventually—as the natural result of competition—be reduced to a level that consumers are willing to pay. This circumstance is not generally understood, because the consuming public has been told repeatedly that fair trade means fixed prices at high levels.

As a further protection to the consumer, state fair trade laws and the McGuire Act do not countenance price-fixing agreements between or among competitors—that is, competitors may not combine to fix prices. Only "vertical"—and not "horizontal"—agreements are permitted under the fair trade statutes.

The problem which confronts the ethical retailers of today is basically one of unscrupulous competition and discriminatory enforcement of fair trade agreements by manufacturers. Price-cutters of fair-traded items in the great majority of cases realize that their activities can be enjoined without too much difficulty by the institution of a suit either by the manufacturers of the products being sold at cut prices or by a competing retailer. But the price-cutters are willing to take the calculated risk because they know that enforcement is difficult and because they feel that even a court order may result in increased sales by them of other articles when the public is advised that they have been enjoined from selling a product below the price fixed by a manufacturer. The sympathy of the public often results in a greater volume of sales.

Everyone has the urge to buy goods as cheaply as possible. However, as President McKinley once put it:[14]

> I do not prize the word cheap. It is not a word of hope; it is not a word of comfort; it is not a word of cheer; it is not a word of inspiration! It is the badge of poverty; it is the signal of distress; . . . [C]heap merchandise means cheap men, and cheap men mean a cheap country.

In the price-cutting wars of the 1930's, we had become a "cheap" country, with a vengeance. However, before long, it was realized that preserving the corner drugstore was more important than saving a few pennies on a tube of toothpaste. Today, the displacement of the small independent businessman presents a grave danger to our economy—and to our society. America should be under no illusions about the value or effect of promiscuous price-cutting. It has, indeed, been a potent weapon of monopoly—a means of killing the small rival.

[14] Campaign speech delivered at Cleveland, Ohio, Oct. 5, 1889, entitled *Protection and Revenue*, in SPEECHES AND ADDRESSES OF WILLIAM MCKINLEY 368, 376 (1894).

II

RETAILERS' REMEDIES

After this review of the basic philosophy of the fair trade statutes, let us now turn to a consideration of the possible avenues of relief for the conventional retailers who distribute fair-traded merchandise.

First, it should be clear that if a retailer is doing business in a state which does not have a fair trade statute, he cannot, *under ordinary circumstances,* be heard to complain that he is being hurt by the price-cutting tactics of his competitor. However, if he finds that his competitor is selling a product either below or only slightly higher than the price at which he is able to buy it from the same manufacturer or producer, it would pay him to query whether his competitor is being favored by a special price from the manufacturer in violation of existing state law and possibly in contravention of the Clayton Act, as amended by the Robinson-Patman Act. Further, even if the manufacturer is not engaging in a discriminatory pricing practice, it may develop that the retail competitor who is cutting prices is "selling below cost" in violation of laws in effect in many of our states. Where interstate commerce is involved, it is also unlawful to sell goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor.[15]

Second, even in a state which does have a fair trade statute, if the particular commodity involved has not been fair-traded by the manufacturer, then, *under ordinary circumstances,* a retailer cannot complain of the price-cutting tactics of his competitor. This statement is, of course, subject to the same qualifications as indicated above concerning possible violations of other state and federal statutes.

But the problem facing most retailers today is not one existing in non-fair trade states and not one pertaining to non-fair-traded items. The problem has to do with price-cutting on items which have been fair-traded in states which have fair trade statutes. What can the conventional retailers do to protect themselves against the inroads being made by the discount houses? Should the conventional retailers "throw in the towel" and imitate the example of the discount houses? Or should they seek to compel adherence to the letter and spirit of our fair trade statutes?

Many manufacturers enter into fair trade agreements with their distributors and then do a fairly conscientious job of policing such fair trade agreements. However, there are some who fair-trade their products and then seek to maintain a "double-dealing standard" by compelling small retail outlets to adhere to the fair trade prices, while at the same time closing their eyes to the open and notorious price-cutting of the discount houses which handle a large volume of goods and which are in competition with the small independent retailers.

As a general principle, the less government intervention in business, the better. However, under certain circumstances, the government has not only a right, but also a duty to supervise the conduct of business in the public interest. Government

[15] 49 STAT. 1528 (1936), 15 U.S.C. § 13a (1952).

should come into the picture only to assure that the rules of the game are fair and that they are enforced in a way that will enhance our economic productivity.

Section 5(a)(1) of the Federal Trade Commission Act provides very generally that:[16]

> Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are hereby declared unlawful.

But what are unfair methods of competition? What are unfair acts or practices? What are deceptive acts or practices? These are very important questions which the Federal Trade Commission has, for many years, been answering. The basic law itself is not definitive; and it probably was not made definitive because Congress could not possibly have enumerated all of the unfair methods of competition and all of the unfair or deceptive acts or practices capable of being engaged in by businessmen. Consequently, from time to time, the Federal Trade Commission is called upon to determine whether a new method of competition or a new act or practice is violative of the statute because it is unfair.

Given a set of circumstances wherein a manufacturer picks and chooses those against whom he will seek enforcement of the minimum resale price provision, is there any legislative authority for the FTC to intervene and enjoin such discriminatory practice? In my opinon, there is. The Commission, for about forty years now, has been attempting to ban unfair methods of competition in commerce. Since 1938, the Commission has also sought to ban unfair or deceptive acts or practices in commerce. The Clayton Act, as amended by the Robinson-Patman Act, prohibits certain specified discriminatory practices in commerce. The theory of all of these laws has been that competitors should start their race at the same starting point. If this is correct, is it fair for a manufacturer to compel one distributor to abide by a minimum resale price provision in a fair trade agreement, and at the same time sell to a competitor of such distributor (let us call that competitor a discount house) and not require the competitor to respect the minimum resale price fixed by the manufacturer?

Some might ask: "If the Federal Trade Commission should take such action, would it not in effect be seeking enforcement of the fair trade agreements?" The answer is "No." The Commission would not be seeking to enforce any agreement. It would only be seeking ***equal treatment of all distributors*** of the same manufacturer. It is submitted that the FTC has full authority to enjoin a manufacturer from discriminating in this manner. In compliance with an order of the Commission, the manufacturer would have the choice of doing one of two things: He would subsequently either have to enforce his minimum resale price provision against all distributors; or he would have to abandon all fair trade agreements. The choice would be up to the manufacturer; the Federal Trade Commission would not order him either to enforce or not to enforce the provisions of fair trade agreements. All that the Commission could order him to do would be to treat all distributors alike.

[16] 66 STAT. 632, 15 U.S.C. § 45(a)(1) (1952).

If this step were taken by the Federal Trade Commission, could it be accused of going beyond congressional intent? That any such criticism would be unjustified seems clear from a perusal of some of the provisions of the Clayton Act, as amended by the Robinson-Patman Act. Section 2(d) of the Clayton Act makes it unlawful for any person engaged in commerce to pay a customer for services or facilities unless such payment is available to all competing customers on proportionally equal terms.[17] Section 2(e) prohibits the furnishing to one purchaser of services or facilities not accorded to all others on proportionally equal terms.[18]

Obviously, the congressional intent was that customers be treated either equally or on proportionately equal terms. However, where a seller in interstate commerce offers a purchaser a contract with ten restrictive provisions, and at the same time offers to a competitor of such customer a contract with only nine restrictive provisions, it appears that the latter may receive a competitive advantage over the former and that this, in turn, may substantially lessen competition or tend to create a monopoly. (For purposes of the example, the tenth restrictive provision might be one pertaining to the maintenance of minimum resale prices.)

Let me not be misunderstood as stating that the discriminatory enforcement of the minimum resale price provisions of a fair trade agreement violates the Clayton Act, as amended by the Robinson-Patman Act. If there is a violation of law—and it is submitted that there is—then the violation is of section 5(a)(1) of the Federal Trade Commission Act.

Another matter of importance in connection with this problem concerns the rather widespread impression that the Sherman Act is violated if two or more retailers, or two or more wholesalers, combine to enforce compliance with a legal fair trade agreement. It is submitted that two or more individuals, whether or not competitors on the same business level, may combine when they seek *only* the enforcement of a legal contract. Very often, small retailers are not financially able to undertake the expense involved in bringing one or more suits against competitors who violate fair trade agreements. If two or more retailers may not combine and share legal expenses, it may mean that their businesses will be ruined and the discount house or discount houses in the area will subsequently enjoy a monopoly in the area for the distribution of the particular merchandise involved.

There is no question that responsibility for fair trade enforcement lies primarily with the manufacturers. Nevertheless, the fair trade laws generally provide that any injured party may undertake enforcement; and frequently, a retailer is in a better position to obtain fair trade enforcement than the manufacturer himself, since a retailer can seek an injunction against price-cutting on all fair-traded items offered for sale by him and by the discount house, but a manufacturer's complaint would necessarily have to be restricted to his own fair-traded products.

[17] 49 STAT. 1526 (1936), 15 U.S.C. § 13(d) (1952).
[18] *Id.* § 13(e).

If two or more injured retailers may combine in a suit to enforce one or more fair trade contracts, it seems logical to conclude that a manufacturer may combine with one or more of his retailers for the same purpose. With retailers filing the suits and with the manufacturers defraying the costs, a system of fair trade enforcement of maximum efficiency and of maximum economy would seem to have been discovered.

It is understood that small businesses have already been closed and bankruptcies have resulted because of the practices of discount houses. For their own self-preservation, retailers should solicit the assistance of the FTC when manufacturers discriminate in their enforcement of the minimum resale provision of fair trade agreements. Further, if retailers feel that they should protect their business by combining with their competitors *only* for the purpose of seeking compliance with fair trade agreements, and if the Department of Justice should advise them that such a combination may be deemed to violate the Sherman Act, then such businessmen should ask the Department to co-operate with them in bringing about a test case of this interpretation. In this same connection, it is interesting to note the statement of Federal Trade Commissioner Secrest at a recent Trade Practice Conference in Chicago:[19] "You can't be accused of collusion if you all get together to enforce the law. Now, if you get together to break it, you would be in collusion." Although Commissioner Secrest was referring to combinations of competitors to secure enforcement of Trade Practice Rules promulgated by the FTC, the principle seems applicable to combinations to enforce fair trade agreements.

In order to gain first-hand knowledge about fair trade, a subject of vital concern to small business, the Subcommittee on Retailing, Distribution, and Fair Trade Practices, of the Senate Select Committee on Small Business sought information from the manufacturers, distributors, and retailers who are actually practicing fair trade. During this survey conducted in mid-1956, when asked about the probable effect on their companies and industries if the Miller-Tydings and McGuire Acts were repealed, 231 firms felt that there would be substantial adverse effect upon their companies specifically and the industry as a whole. One manufacturer voiced apprehension over the status of small business, saying:[20]

> We would consider that very serious effects would be encountered by our firm, as well as other small industries, should the Miller-Tydings Act and the McGuire Act be repealed. The reason for our concern is that big business with its unlimited capital and huge resources, could stand a program of narrow margins of profit should cutrate prices prevail in the wholesale and retail field, whereas small businesses would be seriously crippled and perhaps wiped out; in view of the present standard of inflation now prevailing in this country, and with the cost of doing business going up percentagewise a large group of small businesses would be wiped out should the two acts heretofore mentioned be repealed.

[19] FTC Transcript of Trade Practice Conference for the Work Glove Industry, Oct. 10, 1958.

[20] Select Committee on Small Business of the Senate, *Fair Trade*, S. REP. No. 2819, 84th Cong., 2d Sess. 11 (1956).

III

THE FTC POSITION

The Federal Trade Commission, on February 21, 1955, announced that it had denied an application for a Commission investigation into resale price agreement enforcement practices of certain unnamed manufacturers in the jewelry industry. In requesting action by the Commission, the applicants had charged that the manufacturers were using retail jewelers as a "show case stimulus to the business of discount houses" by forcing jewelers to hold to fair trade prices while allowing or encouraging discount houses to undercut fair trade prices.

In a letter to the applicants, the FTC rejected the theory that the applicants were engaged in unfair methods of competition in violation of the Federal Trade Commission Act. Because of its importance, the letter is quoted in full in a footnote.[21]

[21] "Dear Sirs:

"Reference is made to your application to the Commission on behalf of ——————————, in which you complain of alleged unlawful practices of certain unnamed manufacturers of watches, silverware, appliances, and related goods. You charge therein that these manufacturers discriminate between competing distributors of their product by deliberately selling fair-trade merchandise to so-called discount houses without requiring adherence to the fair trade prices, at the same time enforcing fair trade prices against retail jewelers. The purpose of such discrimination, it is alleged, is to establish the fair-traded retail jewelers as a 'show case stimulus to the business of discount houses.' The application charges that the disparate treatment of competing groups constitutes an unfair method of competition in violation of section 5 of the Federal Trade Commission Act. The Commission is requested to initiate an immediate investigation into the cited activities.

"The matter has been given intensive study by the Commission. For purposes of settling the legal issues involved, all factual allegations of the application, however controversial, have been construed in a light most favorable to the application.

"The Commission nevertheless decides, for the reasons set forth below, that the matter is not one in which Federal Trade Commission jurisdiction could be invoked.

"The authority of the Federal Trade Commission under fair trade is sharply circumscribed by the provisions of the McGuire Act. The Act does not impose on the Commission any affirmative regulatory duties; it does not in terms prohibit any practice nor require the Commission to take corrective action towards proscribed activities. The Act is exemptive and permissive. It specifies the conditions under which fair trade pricing and the rights of action created by State fair trade laws are exempt from the Federal antitrust laws.

"The Commission has consistently taken the position that it is not within the province of the Federal Trade Commission to exercise control over resale price agreements nor to enforce such agreements. Where resale price agreements are lawful under applicable State law, the Commission understands the McGuire Act as barring antitrust authorities from concerning themselves with the rights and obligations brought into existence by those agreements. Enforcement has been left exclusively to private litigation.

"The Commission agrees, however, that the withdrawal from the area of lawful fair trade should not be given too broad a connotation. It is fairly apparent that in varying competitive contexts—where the practice is not 'lawful,' or it is an integral part of a greater trade restraint—it may be attacked under the Federal antitrust laws. (*Cf. United States v. Univis Lens,* 316 U.S. 241 (1942); *United States v. Bausch & Lomb Optical Co.,* 321 U.S. 707 (1944); *Eastman Kodak v. F.T.C.,* 158 F.2d 592 (1946).) But no contention is here made that the fair trade agreements entered into by these manufacturers are unlawful. The application apparently rests on the theory that the manufacturers utilize the device of fair trade to affect a larger competitive restraint—that is, an unlawful discrimination between competing channels of distribution in violation of section 5 of the Federal Trade Commission Act. The Commission cannot validate that theory.

"The application declares that remedies and corrective procedures made available at State Law, 'have proved completely ineffective to remedy the wrong' and are 'not the answer to the problem.' These remedies inhere in the right afforded the manufacturer, competing retailers, and any person damaged by the willful and knowing action of sellers undercutting the fair trade price to bring an action in State court. The action may be either a damage suit, where the violator is a signatory to a fair trade

With respect to the Commission's position that the McGuire Act does not impose upon the FTC any affirmative regulatory duties and does not in terms prohibit any practice or require the Commission to take affirmative action towards proscribed activities, it is important to examine the McGuire Act closely. The first section sets forth the purpose of the legislation,[22] and the second amends section 5(a) of the Federal Trade Commission Act by adding four new paragraphs, numbered 5(a)(2) through 5(a)(5). Paragraphs 5(a)(1) and 5(a)(6) are not new, but they are included in the McGuire Act as part of the amended section 5(a) of the Federal Trade Commission Act.

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contract, or a suit for injunctive relief which is available against signers and nonsigners alike. Assuming the truth of applicants' allegation that no relief against price cutters has been forthcoming from the manufacturers, it is still clear that applicants may resort to various avenues of self-help to correct the conditions of which they complain.

"In the first instance, fair-trading retailers may sue for injunctive relief against offending discount houses under the applicable State Acts. Relief would not be conditioned upon proof of the manufacturer's intent or of his complicity in the price cutting; proof need only be shown of the discounter's knowledge and willful disregard of the fair trade price.

"But beyond injunctive relief against competing discounters, retailers have a further broad area of self-help available: disregarding the resale prices fixed by the manufacturer and competing on a price basis with the discount houses. The decisions of State courts under the fair trade acts make it clear that where a manufacturer discriminates in the enforcement of his resale prices among competing customers, or fails to display reasonable diligence in enforcement, or neglects to enforce, that fact constitutes an adequate defense in a later enforcement proceeding by the manufacturer against a price-cutting seller. These decisions invoke the equity principle of 'unclean hands' against the manufacturer, or hold that he has 'waived' his rights under the contract, or 'abandoned' his rights under the State statute. Thus, a retailer forced to cut prices to compete, under conditions here alleged, could do so with impunity.

"The application has sought to anticipate this second self-help technique by declaring that a retailer is not himself required to violate a contract, law, or public policy to obtain equal footing with his favored competitor, citing in support of this contention *Federal Trade Comm'n v. Keppel & Bro., Inc.*, 291 U.S. 304, 313 (1934), a lottery case, where it was stated:

> 'A method of competition which casts upon one's competitors the burden of the loss of business unless they will descend to a practice which they are under a powerful moral compulsion not to adopt, even though it is not criminal, was thought to involve the kind of unfairness at which the statute was aimed.'

Inferentially, the status of retail jewelers is equated with that of the disfavored competitors in *Keppel*. But the present situation differs markedly from *Keppel*. As a matter of law, if a manufacturer has persisted in the course of conduct here alleged, he has forfeited his rights to enforcement and there is no longer any legal obligation—or at least any legally enforceable obligation—upon a retailer to continue to observe the manufacturer's fixed prices. In contrast to the lottery method of *Keppel*, it cannot seriously be suggested that price competition is morally reprehensible.

"The Federal Trade Commission must act in the public interest, to affirm, wherever possible, the basic competitive rationale of our free enterprise economic system. The Commission believes that the applicants here, through their own lawful efforts, may obtain the relief desired. In the absence of a showing that circumstances foreclose such efforts, the Commission cannot invoke antitrust sanctions in support of aggrieved applicants reluctant to effect that measure of self-help which would alleviate their condition.

"No ground is cited which affords a present basis for a proceeding under section 5 of the Federal Trade Commission Act.

"The application for an investigation has been denied.

"By direction of the Commission.

Robert M. Parrish
Secretary."

Federal Trade Comm'n Press Release, Feb. 21, 1955.

[22] 66 STAT. 631, 15 U.S.C. § 45 note (1952). The amended statute, as contained in the Code, does not set forth the purpose of the McGuire Act amendment to the Federal Trade Commission Act. Such purpose, as enacted by Congress, is set forth in the footnote, entitled "Purpose of Act July 14, 1952."

Even if the *new* sections do not impose any affirmative regulatory duties upon the Commission or in terms prohibit any practice, why would the Commission expect Congress to include in these new sections language which was already in the two *old* sections—language reaffirmed by Congress when it passed the McGuire Act. Section 5(a)(1) reads:[23]

> Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are hereby declared unlawful.

Section 5(a)(6), with inapplicable deletions, states:[24]

> The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce.

While the four new sections in the McGuire Act do not, when taken alone, impose upon the Commission any affirmative regulatory duties, and while they do not in terms prohibit any practice or require the Commission to take corrective action towards proscribed activities, how can the Commission ignore the provisions of sections 5(a)(1) and 5(a)(6) which have been part of the Federal Trade Commission Act for many years? Section 5(a)(6) not only empowers the Commission to take certain action, it actually *directs* the Commission to do so. Congress could not have made its intention any plainer!

The four new sections added to section 5(a) of the Federal Trade Commission Act by the McGuire Act merely provide that certain *contracts or agreements* illegal before the enactment of the McGuire Act were cleansed of such illegality by the passage of the McGuire Act. However, there is nothing in the McGuire Act which exempts *practices,* as distinguished from *contracts or agreements,* from the provisions of the Federal Trade Commission Act or of the antitrust laws. Consequently, if a practice was illegal prior to the enactment of the McGuire Act, it is still illegal now, because the McGuire Act exempts only the certain *contracts or agreements* described therein.

Th FTC emphasizes that it has consistently taken the position that it is not within its province to exercise control over, or to enforce, resale price agreements. Obviously, Congress never intended for the Commission to undertake such enforcement. However, if the FTC should take action with a view to enjoining a manufacturer from continuing the practice of enforcing minimum resale provisions of a fair trade agreement against only some of his distributors, would the Commission be enforcing fair trade agreements? Of course not! Instead, the FTC would only be seeking equal treatment of all distributors by the same manufacturer.

Paragraph six of the Commission's letter remarks:

> It is fairly apparent that in varying competitive contexts—where the *practice* is not "lawful," or it is an integral part of a greater trade restraint—it may be attacked under the Federal antitrust laws. (Emphasis added.)

[23] 66 STAT. 632, 15 U.S.C. § 45(a)(1) (1952). [24] *Id.* § 45(a)(6).

However, in the next sentence the Commission adds:

> But no contention is here made that the Fair Trade *agreements* entered into by these manufacturers are unlawful. (Emphasis added.)

Thus, a nimble transition is made from "practices" to "agreements."

Why should "agreements" and their legality be involved in the first place? The jeweler-petitioners were complaining to the Commission about the practice of some manufacturers who discriminate among competing retailers by deliberately selling fair-traded merchandise to the discount houses without requiring adherence to the fair trade prices and at the same time enforcing those prices against other retail jewelers. If the practice is not lawful, it should make no difference whether the agreement involved is a fair trade agreement or any other kind of agreement; and, likewise, it should make no difference whether the underlying agreement is lawful or unlawful.

In its letter, the FTC seems to indicate, though it never expressly so states, that complaining retailers who seek to abide by fair trade agreements should first exhaust all other remedies open to such retailers before they come to the Commission for assistance. While it is true that the complaining retailers do have the right to resort to other avenues of relief, it is not required by any statute that they exhaust such avenues before presenting their problem to the FTC. Section 5(b) of the Federal Trade Commission Act provides, in part:[25]

> Whenever the Commission shall have reason to believe that any such person . . . has been or is using any unfair method of competition or unfair or deceptive act in commerce, and if it shall appear to the Commission that a proceeding by it in respect thereof would be to the interest of the public, it shall issue and serve upon such person . . . a complaint stating its charges. . . .

Thus, the only two statutory prerequisites for FTC action are: (1) the Commission must have reason to believe that a particular person has been, or is, using an unfair practice in commerce; and (2) the Commission must believe that a proceeding by it in respect thereto would be in the public interest. Clearly there is no requirement in the statute that the Commission find that no avenues of self-help are available to the complaining party.

The ninth paragraph of the Commission's letter is especially surprising. There, in effect, the Commission recommends that a distributor violate and ignore the provisions of a valid agreement entered into between himself and the manufacturer. This reasoning that "two wrongs make a right" might involve the retailer who adopted it in some very unfortunate litigation. It is, indeed, extraordinary for the FTC to tender legal advice on a matter that is so controversial and is not covered by any of the laws which the Commission administers.

In the eleventh paragraph of its letter, the Commission emphasizes that it "cannot invoke antitrust sanctions in support of aggrieved applicants reluctant to effect that

[25] 52 STAT. 111 (1938), 52 STAT. 1028 (1938), 15 U.S.C. § 45(b) (1952).

measure of self-help which would alleviate their condition." It has already been noted in this paper that Congress certainly never evidenced any intention to require an exhaustion of remedies. The Clayton Act, as amended by the Robinson-Patman Act, is also an antitrust statute and is also administered by the FTC. Section eleven of that Act provides:[26]

> Whenever the Commission . . . shall have reason to believe that any person is violating or has violated any of the provisions of sections two, three, seven and eight of this Act, it shall issue and serve upon such person . . . a complaint stating its charges in that respect. . . .

Under that Act, the Commission does not even have to hold that a proceeding in respect thereof would be in the public interest. Where then does the FTC find authority for its view that "antitrust sanctions" can only be invoked in favor of those applicants who have already utilized all available self-help?

CONCLUSION

In a recent public address, Senator Hubert H. Humphrey, a leading protagonist for small business in the United States, commented that "there has been considerable evidence in recent years that our business climate contains many elements hostile to the well-being of the average independently-owned and operated small business concerns."[27] The small businesses are fighting hard for survival, and it behooves the federal government to render whatever statutory assistance is possible and consistent with the public interest.

Senator Humphrey also said: "At the present time, the retailer exists in what has been described as an atmosphere of catastrophe." He referred to a statement made by Mr. Victor Lebow, a marketing consultant, who had testified before the Senator's subcommittee during its study of discount house operations. Mr. Lebow told the subcommittee that a retail store opening today has only a seventy-four per cent chance of surviving beyond its first half year of existence; it has a forty-nine per cent chance of living 2½ years; and only seventeen per cent will still be in existence ten years from now.

Obviously, many causes exist for the small businessman's plight—among them: (1) discriminatory pricing practices; (2) combinations and agreements among the larger firms; (3) mergers and consolidations that accentuate the trend towards "bigness"; (4) tax inequities which work to the disadvantage of the smaller businesses; and (5) lack of adequate sources of capital at reasonable interest rates. However, the existence of many other problems for the small businessman does not excuse failure to take steps to stamp out the discrimination in fair trade practices which has been the subject of this paper.

[26] 64 STAT. 1125 (1950), 15 U.S.C. § 21 (1952).

[27] From an address by Senator Hubert H. Humphrey before a convention of the National Association of Retail Druggists, Oct. 2, 1958.

SMALL BUSINESS AND LABOR-RELATIONS PROBLEMS

Eddy S. Feldman*

Those who can find out what to do in organized business are scarce. Those who can find out how to do it are scarcer still.

George Bernard Shaw, Everybody's Political What's What 135 (1945).

Introduction

To the extent that the labor-relations problems of "small" businessmen are distinguishable—in kind—from the labor-relations problems of "large" businessmen, they are so as much because of ignorance and lack of power as because of any fundamentally different treatment in law. Indeed, in relatively few areas in which the law treats of employment relations are there distinctions based upon the size alone.

Distinctions in statutory regulating schemes which are based upon size (perfectly valid constitutional distinctions, by the way[1]) may take the form of variations in volume of business,[2] size of contracts with the federal government,[3] number of

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[1] New York v. Zimmerman, 278 U.S. 63 (1928).

[2] The NLRB is empowered to prevent any person from engaging in certain unfair labor practices "affecting commerce." National Labor Relations Act § 10(a), 49 Stat. 453 (1935), 29 U.S.C. § 160(a) (1952). This specific provision was left unchanged by the Taft-Hartley amendments. 61 Stat. 146 (1947). The Board may cede this power to state agencies by agreement with them if the state statute or construction is not inconsistent with the federal scheme. This statutory grant of power to the Board is most broad, but the Board has never exercised the full measure of its jurisdiction. For a number of years, the Board decided case-by-case whether to take jurisdiction. But in 1950, it concluded that "experience warrants the establishment and announcement of certain standards" which would govern the exercise of its jurisdiction. Hollow Tree Lumber Co., 91 N.L.R.B. 635, 636 (1950). And the Board then published standards, largely in terms of dollar amounts of interstate inflow and outflow. Press Release, October 6, 1950, 26 L.R.R.M. 50. In 1954, a sharply divided Board, see Breeding Transfer Co., 110 N.L.R.B. 493 (1954), revised the jurisdictional standards upward, thus removing many cases from the jurisdiction of the Board. Press Release, July 15, 1954, 34 L.R.R.M. 75. In Guss v. Utah Labor Relations Board, 353 U.S. 1 (1957), the Supreme Court noted, while denying access to an employer to a state agency with reference to a labor dispute covered by the National Labor Relations Act which fell under the existing jurisdictional standards, that there was a "vast no-man's-land, subject to regulation by no agency or court." *Id.* at 10. The Court suggested that "Congress is free to change the situation at will," and that "the National Labor Relations Board can greatly reduce the area of the no-man's-land by reasserting its jurisdiction and, where States have brought their labor laws into conformity with federal policy, by ceding jurisdiction under Section 10(a)." *Id.* at 11. The Board, in its Press Release of October 2, 1958, 42 L.R.R.M. 96, noted the Congress' approval of an appropriation requested by the Board which would allow the extension of the Board's jurisdiction in some of the uncovered area, and announced new standards:

1. *Nonretail:* $50,000 outflow or inflow, direct or indirect. (Direct outflow refers to goods shipped or services furnished by the employer outside the state. Indirect outflow includes sales within the state to users meeting any standard except solely an indirect inflow or indirect outflow standard. Direct inflow refers to goods or services furnished directly to the employer from outside the

state in which the employer is located. Indirect inflow refers to the purchase of goods or services which originated outside the employer's state, but which he purchased from a seller within the state. Direct and indirect outflow may be combined, and direct and indirect inflow may also be combined, to meet the $50,000 requirement. However, outflow and inflow may *not* be combined.) (1954—$50,000 outflow, $500,000 inflow, $100,000 indirect outflow, $1,000,000 indirect inflow.)

2. *Office buildings:* Gross revenue of $100,000 of which $25,000 or more is derived from organizations which meet any of the new standards.
(1954—Employer who leases or owns and who operates must be otherwise in commerce and utilize building primarily to house its own offices.)
3. *Retail concerns:* $500,000 gross volume of business.
(1954—Direct inflow of $1,000,000, or indirect inflow of $2,000,000 or direct outflow of $100,000.)
4. *Instrumentalities links and channels of interstate commerce:* $50,000 from interstate (or linkage) part of enterprise or from services performed for employers in commerce.
(1954—$100,000.)
5. *Public utilities:* $250,000 gross volume, or meet standard 1 (nonretail).
(1954—$3,000,000 gross volume.)
6. *Transit systems:* $250,000 gross volume. (Except taxicabs, as to which the retail ($500,000 gross volume of business) test shall apply.)
(1954—$3,000,000 gross volume.)
7. *Newspapers and communications systems:* Radio, television, telegraph, and telephone: $100,000 gross volume. Newspapers: $200,000 gross volume.
(1954—$500,000 test for newspapers, $200,000 for the others.)
8. *National defense:* Substantial impact on national defense.
(1954—$100,000 in goods or services directly related to national defense, and pursuant to government contract.)
9. *Business in the Territories and District of Columbia:*
D.C. .... Plenary.
Territories .... Standards apply.
(Same as 1954.)
10. *Associations:* Regarded as single employer.
(Same as 1954.)

It appears that the Board may never get around to entering into any cession agreements because of the difficulty of complying with the conditions imposed on them by § 10(a). Guss v. Utah Labor Relations Board, *supra.* As to the validity of the Board's criteria for exercising jurisdiction, see Hotel Employees Local No. 255 v. Leedom, 358 U.S. 99 (1958).

The maxim *de minimis non curat lex* may cause an administrative agency to refuse to take jurisdiction of a given situation over which it might normally be expected to exercise such jurisdiction. See, *e.g.*, National Labor Relations Board v. Denver Bldg. and Const. Trades Council, 341 U.S. 675 (1951). The Attorney General for Pennsylvania argued before the Pennsylvania Supreme Court recently that a window cleaning company doing annually $40,165 in volume of which $12,162 was derived from services to 25 companies affecting interstate commerce would not be considered for relief by the National Labor Relations Board under the *de minimis* doctrine. 43 L.R.R.M. 71 (1958).

Under the Fair Labor Standards Act, minimum wage and overtime provisions do not apply with respect to employees working on newspapers whose circulation is less than 4,000 (if the major part of this circulation is in the county where it is published or in contiguous counties), to switchboard operators who work in public telephone exchanges which have not more than 750 stations, or to employees or proprietors of telegraph agencies in exempt retail establishments if the telegraph message revenue of the agency does not exceed $500 per month. 52 STAT. 1067 (1938), 29 U.S.C. § 213(a) (1952).

[8] Walsh-Healey Public Contracts Act, 49 STAT. 2036, 41 U.S.C. §§ 35-45 (1952), which provides that any contract made by any department or agency of the United States, the District of Columbia, or by any corporation all the stock of which is beneficially owned by the United States for the manufacture or furnishing of materials, supplies, articles, and equipment in any amount exceeding $10,000 must include provisions relating to the level of wages paid and overtime restrictions. A contractor may carry on business with the Government well in excess of $10,000 and still not be subject to the Act, so long as no one contract exceeds $10,000.

personnel employed,[4] number of employees covered under pension and welfare plans,[5] and the specific activity of the employer, which may incidentally and by its nature be "small."[6] These various distinctions imply "smallness" versus "bigness," and while it would ease this analysis by having at hand a convenient, arbitrary definition of small business, there is really no completely satisfactory way of dividing employers into these two groups. Perhaps it will prove adequate merely to refer to these two classes as though one knew exactly which they embrace and leave it to the individual entrepreneur to choose the more fitting description for himself.

Having, however, set out these few instances in which size of the employer may determine whether a given statutory scheme may apply to him, we are thrown back to discovering the basic reason why one should discuss *small* business labor relations problems at all. Are they really different *in kind* from the problems of larger business?

To a practitioner, it does not appear that such labor problems as a small businessman may have are different radically from those of his larger counterpart. What does appear to be different is the variation in attitudes and methods of solving these problems. These seem to spring from the fact that smallness implies some other characteristics which enter dynamically into the problem situations. As we noted before, smallness frequently implies less knowledge of management techniques and of legal rights, duties, and remedies. It also implies a lesser residuum of "power" in the individual employing unit.[7] These two characteristics of smaller business can, and do, justify some distinctive descriptions of small business labor problems.[8]

I

NONCOLLECTIVE BARGAINING PROBLEMS

In the first place, it may be well to separate the field into collective bargaining problems and all other labor-relations problems. For the most part, the small

[4] INT. REV. CODE OF 1954, § 3306(a), provides that the only employers subject to the Federal Unemployment Tax Act are those who employ four or more persons for not less than twenty days each year.

[5] The provisions of the recently passed Welfare and Pension Plans Disclosure Act, 72 STAT. 998 (1958), 29 U.S.C.A. § 303(b)(4) (Supp. 1959), effective January 1, 1959, are not applicable to employee welfare or pension plans if they do not cover more than twenty-five employees.

[6] Note, *e.g.*, in California, the exclusions from unemployment insurance coverage of "domestic service in a private home," "services performed as a real estate, business opportunity, mineral, oil or gas, or cemetery broker or salesman by an individual who is licensed in one of such classes by the State and who is remunerated solely by way of commission," and "services performed [by an individual as a golf caddy] in caddying or carrying a golf player's clubs." CAL. UNEMPLOYMENT INS. CODE, div. 1, pt. 1, art. 2, §§ 629, 650, 651. See also National Labor Relations Act, *supra* note 2, § 2(3).

[7] See the interesting, if not always pellucid, papers presented at the 1958 Meeting of the Industrial Relations Research Association on the theme, *Power in Industrial Relations—Its Use and Abuse*, published in 9 LAB. L.J. 615 *et seq.* (1958).

[8] The identity of ownership and management in the small business, in contradistinction to their separation in the larger corporation, will also help explain the differences in viewing labor-relations problems.

businessman is not unlike all other businessmen when it comes to whether he must, under the appropriate criteria, pay a premium for overtime work, pay not less than a minimum wage, refrain from hiring minors, provide safe, healthful, and comfortable conditions of employment,[9] pay taxes for unemployment compensation benefits, buy insurance to cover the claims arising from injuries of his employees on the job, or not discriminate in hiring because of race, creed, or color. Unless he is outside the application of the legal standard for some "nonsize" reason, he has the same obligations as any other employer.

The small businessman's troubles begin when, because of lack of knowledge of the obligations imposed upon him by statute or by the law of the collective bargaining agreement to which he may be a party, he fails to live up to those obligations and he is called upon by someone—an aggrieved employee or a governmental agency—to conform to them. (This is not to gainsay that the small employer may well know his obligations and intentionally seek to avoid them. Certainly such attitudes do exist: an employer may be looking for gain for himself or he may be driven to his actions by a desire to remain in business if he is not able to see any other way of doing so. There probably can be no abstract justification for deliberate law-evasion when the legislative body has decreed the obligations which must be met by any entrepreneur who wishes to employ people in his enterprises.) He may have a general knowledge of his obligations but be trapped into specific error by his unawareness of nonobvious interpretations of law by administrators or courts of both.

A good illustration of the opportunity for expensive error is the overtime provisions of the Fair Labor Standards Act. Section 7(a) of that statute requires that a covered employee shall receive compensation for hours worked in excess of forty "at a rate not less than the regular rate at which he is employed." The Administrator of the Wage and Hour Division has interpreted this to mean that where employees are compensated on an incentive earnings basis, the regular rate of pay is the rate found by dividing the hours worked in the work week into the total earnings during this same period.[10] Now, most collective bargaining agreements contain specific hourly rates for the various job classifications covered in them, and these will generally be lower than the average hourly rate computed for "pieceworkers." (Even in the absence of a collective bargaining agreement, an employee is usually hired in

Where there is this identity, there is a tendency to accept a solution of expediency and to work out a *modus operandi* in as resourceful a way as possible. For a provocative discussion of the significance of the separation of ownership and management, see ADOLF A. BERLE, JR., ECONOMIC POWER AND THE FREE SOCIETY, A PRELIMINARY DISCUSSION OF THE CORPORATION (1958).

[9] "It shall be the continuing duty of the Industrial Welfare Commission . . . to ascertain the wages paid and the hours and conditions of labor and employment in the various occupations, trades, and industries in which women and minors are employed in this State, and to investigate the comfort, health, safety, and welfare of such women and minors." CAL. LABOR CODE § 1173. "Every employer in any establishment employing any female, shall provide suitable seats for all female employees and shall permit them to use such seats when they are not engaged in the active duties of their employment." CAL. LABOR CODE § 1253.

[10] 29 C.F.R. § 778.3(b)(2).

at some stated time rate, with an understanding that he should be able to earn more by the operation of the incentive system. In any case, the covered employee may not be paid less than the statutory minimum wage.) It has not been unknown, however, for an employer to use the "straight" hourly rates for the computation of overtime premium, because he could quite reasonably conclude that "regular rate" in the statute (if he is inclined to reading statutes) means an unchanging rate from week to week. The Administrator's interpretation in this instance has stood the tests of litigation and subsequent congressional review,[11] but these subtleties are not necessarily part of the stock of managerial knowledge possessed by small entrepreneurs.

Unquestionably, operating any business in today's complex society is an intricate art which requires knowledge of many disciplines, together with the administrative ability to integrate them and apply them to the enterprise. Running a *small* business requires no less knowledge, but even this fact eludes the small businessman. The small entrepreneur many times is not at all aware that he has any problems—until it is too late. And granted the knowledge of problems, there may be—and usually is—a reluctance to spend the money to acquire people with the expertise to overcome the lack of information.

One may assume that the smaller businessman being discussed here is not himself a professional accountant or lawyer. On the one hand, he will employ bookkeepers and auditors as a matter of course. More likely than not, on the other hand, he will retain legal counsel only when trouble has arisen. No matter why this reluctance to seek preventive legal advice,[12] he is usually well on his way to legal trouble when he gets round to retaining counsel.

It may be concluded, therefore, that in ordinary noncollective bargaining situations, knowledge of obligations is the important thing in employment relations.[13] The small businessman has many sources available for the acquisition of knowledge: administrative agencies; trade associations and chambers of commerce;[14] professional advice of lawyers, accountants, and business consultants; business services; and other publications. Experience teaches one that many small businessmen do not avail themselves of these aids, and until they reach an understanding that knowledge is strength, and probably money as well (even if only in the sense of penalties not incurred), they will continue not availing themselves of the knowledge.

[11] For a review of this matter, see Feldman, *Algebra and the Supreme Court*, 40 ILL. L. REV. 489 (1946).

[12] The useful concept of preventive law which contemplates a periodic "legal check-up" has been developed in great depth by LOUIS BROWN, MANUAL OF PREVENTIVE LAW (1950), and has been effectively applied in his valuable book, HOW TO NEGOTIATE A SUCCESSFUL CONTRACT (1956). See, also, LOUIS BROWN, YOUR LEGAL FACTS: INFORMATION FOR YOUR ATTORNEY (American Bar Foundation, Reproduction Ser. No. 3) (1957).

[13] The small employer should not overlook the usefulness of good personnel practices. See FRANCES B. TORBERT, PERSONNEL MANAGEMENT IN SMALL COMPANIES (1958).

[14] See WILLIAM SMITH, LOCAL EMPLOYERS' ASSOCIATIONS (1955).

II

COLLECTIVE BARGAINING PROBLEMS

When we contemplate the small businessman and collective bargaining, we enter another world, almost, where knowledge is, of course, vastly important, but where accretions of power will determine the course along which the small businessman will go.

Whether he is organized or not, the small businessman is concerned with collective bargaining. If he has a choice of location, he is likely to avoid an area where union organization is prevalent. But other considerations may determine location: the desire to live in a certain city or part of the country, availability of materials, existence of a skilled labor supply, and access to customers. In the latter situations, the entrepreneur may have more immediate concerns with union organization.

If he is confronted with an organizational campaign among his employees, or if he is simply asked to sign a contract without consultation with or consideration of the wishes of his employees, he is faced with the necessity for making decisions he is quite possibly ill-equipped to make. While it is not invariably true that an employer will seek to avoid organization, it is probably the case that he would regard himself better off without it. His first inclination is to resist organization, and it is at this point that his need for knowledge becomes acute and that he should become aware of the necessity of evaluating his own power residuum. In the absence of any applicable labor relations statute, he may rely on his own knowledge and upon his own evaluation of the power relationships, and he may not fare badly. However, he is not likely to know the extent of the proscriptive restrictions on his own actions if he is an employer covered by a labor relations statute at some level. For example, during an organizing campaign he may discharge some employees wrongfully and unwittingly incur expensive back wage payments. He could possibly have achieved his same objectives by communicating with his employees, but he may have refrained from this course of action under a misconception that he must maintain complete neutrality.[15] Even the answer to the threshold question of whether he is a covered employer will dictate the appropriate course of action. If it is answered incorrectly, the results may be costly.

When the organizing group is seemingly unable to obtain a majority of employees to join it (as evidenced by its unwillingness to go to a representation election to be conducted, say, by the National Labor Relations Board) an employer may himself want to go to the Board. But he may find that this is not as simple as it sounds. First, as we have already seen, the Board's jurisdictional standards may exclude him from its services. Then, even if he gets there, he may find that the delay due to dilatory moves by the union or other participants or by virtue of the agency case-

[15] Where an employer had rules against the solicitation of any kind on company property and the distribution of literature or posting of signs and it enforced them during an organizational campaign of competing unions, but where it distributed eight pieces of antiunion but noncoercive literature, the employer was guilty of an unfair labor practice. United Steelworkers of America v. NLRB, 243 F.2d 593 (D.C. Cir. 1956).

load is as damaging to him as if there were no agency. True, in some cases, Board procedure may be speeded up because of the nature of the dispute;[16] yet, in the case of the *small* businessman, *any* delay may be hurtful, if not fatal.

Quite possibly, the employer may not wish his case to be in Board hands, at all. If the organizers feel they have a majority, they will file for a representation election. In this event, the employer may wish to be free of Board interference, because he will want to be able to handle his own problems without governmental intervention. A broadening of the Board's jurisdictional standards in this case will not be desirable if the employer wishes to exercise his rights in accordance with local law. The existence of the so-called "no-man's-land" does not displease or inconvenience this employer. It is difficult, therefore, to generalize as to what course of action in this respect should be taken by government,[17] although what is thought by the community to be good for big business labor relations should be no less good for small business labor relations.

One might naturally suggest that the administrative delay be reduced, although one man's delay may be another man's obtaining of justice.[18] Delay is not uniquely a small business problem, though, for it plagues the larger business, too.

It is always problematical how long any employer of limited resources in a relatively well-organized community can withstand a determined organizing effort.[19] Not that every small employer need collapse and beg for the best possible contract whenever a union organizer shows up at his factory or store. Nevertheless, the cost of resistance may be high,[20] and unless the employees show determined refusal to succumb to the blandishments of the organizers, few small employers can sustain the pressure.[21]

[16] As in secondary boycott cases, where the NLRB must give priority to charges filed under § 10(1) of the National Labor Relations Act, 49 STAT. 453 (1936), 29 U.S.C. § 160 (1952).

[17] The Small Business Administrator had at one time thought that the NLRB should broaden its standards considerably more than it eventually did. He apparently communicated this concern to the Board, as reported in the Washington Post and Times Herald, Sept. 4, 1958, p. D7, col. 8. Later he appears to have indicated that the Board's proposed standards were too encompassing. Column of Drew Pearson, Los Angeles Mirror-News, Nov. 4, 1958, p. 19, col. 7-8.

[18] Or as the executive secretary of the NLRB has put it: ". . . one man's red tape is sometimes the other man's due process." *Hearings Before the Senate Select Committee on Improper Activities in the Labor or Management Field,* 85th Cong., 2d Sess. pt. 41, at 15691 (1958). The statement was made in conjunction with hearings into the matter of a trucking company (with seven employees) which complained that it was forced out of business (apparently due to secondary boycotts) while representation proceedings were pending before the Board.

[19] The organizing techniques are varied. Unorganized small merchants, for instance, in shopping centers may find the entire shopping center is being picketed. Amalgamated Meat Cutters v. Fairtown Meats, Inc., 353 U.S. 20 (1957); Note, *Shopping Centers and Labor Relations Law,* 10 STAN. L. REV. 694 (1958).

[20] See testimony before the Senate Select Committee on Improper Activities in the Labor or Management Field that the Southwestern Motor Transport had lost $1,000,000 through a boycott that began in 1954. N.Y. Times, Nov. 18, 1958, p. 27, col. 1.

[21] Some do. See the testimony of the President of the Galveston Truck Lines, Inc., before the Senate Select Committee on Improper Activities in the Labor or Management Field, describing his energetic activities and extensive litigation, while the Teamsters Union sought to organize his company, against the hot-cargo clause, before the Interstate Commerce Commission, and under the Taft-Hartley, Sherman, and various state antitrust acts. *Hearings, supra* note 18, at 15597-625.

Once the small employer is organized, or he has agreed to recognize the union, a contract must be worked out and an entirely new set of problems confronts him. Again, the relative lack of knowledge, experience, and power will work to his detriment unless he takes steps to acquire the knowledge and neutralize the complex of power. And, again, the problems of the small employer are different only in degree from those of the larger employer. They will take their form from many external factors, such as the extent of collective bargaining in the area and in the trade or industry of which the employer is a part, the relationships between production and teamster employees and their unions, the responsibility of local union leadership, the attitude of the entrepreneur, and his ability to pass on increased costs to his customers.

Knowledge of what conditions the union has obtained from other employers in the industry is absolutely essential so as to enable the employer to negotiate from a position of some strength. Obtaining this knowledge may be difficult, until one joins an employers' organization. The appropriate association will be able to supply knowledge about working conditions and, if it engages in collective bargaining, to enhance power through joint efforts and employer solidarity.[22] Unfortunately, small employers frequently do not know of the existence of such organizations[23] until the fact situation becomes irretrievable; or they are unwilling to spend a little money for counsel in trying circumstances. But lack of knowledge and power in negotiating will lead to needlessly higher wage rates and more onerous administrative conditions, as well as to restrictions which may deprive the employer of needed freedom to adopt techniques of production[24] and compensation which will enable him to survive.

Joint collective bargaining on the employers' side will at least lead to consistent contract terms for every employing unit; and if the group is confronted with the ultimate weapon—the strike—the possibility that all employers will shut down if one of them is struck may conceivably act as a restraining influence on the union.

In areas where unions are strong (and where teamster union power in combination with other unions is great), the hapless employer is often at their mercy when it comes to negotiating contract terms. While there may be a trend to uniformity and a development of "patterns" on the part of the settlements, unions are in a real sense limited in the wages and conditions they may exact by their knowledge that if some limit is exceeded, the employer will be forced out of business and the union members will lose their jobs. Employers cannot rely on these limitations on unions, though, and power must be faced with power.

[22] In addition to the literature referred to in NLRB v. Truck Drivers Local Union No. 449, 353 U.S. 87, 95-96, nn. 23, 24, 25 (1957), see JESSE T. CARPENTER, EMPLOYERS' ASSOCIATIONS AND COLLECTIVE BARGAINING IN NEW YORK CITY (1950); CLARENCE E. BONNETT, HISTORY OF EMPLOYERS' ASSOCIATIONS IN THE UNITED STATES (1956); HENRY W. EHRMANN, ORGANIZED BUSINESS IN FRANCE (1957).

[23] Some unions may indicate to a newly-won shop that it should join a given employers' association and thus obtain a "standard" industry contract.

[24] See the attack on "methods-time-measurement" (M-T-M) by the Upholsterers' International Union. UIU Journal, July 1958, p. 4.

By combining employing units, small employers may wield great power.[25] The problem is getting the small employers to get together in the first place and getting them to remain together in the face of negotiating crises. In the latter instance, it may be difficult to keep the group from breaking up for any length of time because of financial instability or because of sheer opportunism on the part of individual employers.

CONCLUSION

Smaller employers have the same labor relations problems, we now see, as larger employers. The problems differ in degree only, not in kind. But the approach of the small businessman unused to employing professional counsel will be relatively unskilled and less farsighted than that of his larger counterpart.

Essentially, the course for the small businessman is clear: he must obtain knowledge and power. If he is to be successful, he must work at this quest just as much as at any other phase of his business, be it design, finance, or sales. And he must be prepared to pay for this knowledge and power, just as he would for any other element of his enterprise. There need be no special legislation, special agencies, special counsel for any small businessmen in this area of activity. There must be only a special desire and special effort to acquire the knowledge and strength needed for carrying out any policy decisions which the small businessman may have made.[26]

[25] The union struck one member of an eight-member employer bargaining association as part of a "whipsawing" strategy. The next day, the other seven members laid off their employees, whereupon the union subsequently filed an unfair labor practice charge with the NLRB. The Supreme Court upheld the employers' actions. "Although the [National Labor Relations] Act protects the right of the employees to strike in support of their demands, this protection is not so absolute as to deny self-help by employers when legitimate interests of employees and employers collide. Conflict may arise, for example, between the right to strike and the interest of small employers in preserving multi-employer bargaining, as a means of bargaining on an equal basis with a large union and avoiding the competitive disadvantages resulting from non-uniform contractual terms. The ultimate problem is the balancing of the conflicting legitimate interests. The function of striking that balance to effectuate national labor policy is often a difficult and delicate responsibility. . . ." NLRB v. Truck Drivers Local Union No. 449, 353 U.S. 87, 96 (1957). Under similar circumstances, it is quite likely that unemployment insurance benefits will not be awarded to the locked-out employees. Feldman, *Unemployment Insurance: Its Effect on Trade Disputes in California*, 5 U.C.L.A. L. REV. 604 (1958).

[26] MYLES L. MACE, THE BOARD OF DIRECTORS IN SMALL CORPORATIONS (1948). "Though every individual is unique and different, separate laws cannot be made for every individual; therefore, the individual must fit himself to the law instead of having it fitted to him." GEORGE BERNARD SHAW, EVERYBODY'S POLITICAL WHAT'S WHAT? 192 (1944). The special counsel of the AFL-CIO, Mr. Arthur J. Goldberg, has suggested the creation of a government-sponsored Labor-Management Assembly. The "present membership of the Business Advisory Council, enlarged by representative small businessmen [should] constitute the industry representation." AFL-CIO News, Nov. 15, 1958, p. 6, col. 3. Provided that such a body could serve a constructive purpose, it would certainly give more validity to the Assembly's conclusions.

THE TREND IN CONCENTRATION AND ITS IMPLICATIONS FOR SMALL BUSINESS

GIDEON ROSENBLUTH*

INTRODUCTION

The controversy regarding the trend in concentration may be summarized in bald and oversimplified terms as follows: According to the extreme view on one side, both technology and the dynamics of business are making for increasing concentration. In one line of business after another, small firms are being displaced by giant corporate combines, so that the small independent businessman, the "entrepreneur" of classical economic theory, is gradually disappearing from the scene.

This view has a long history and can be traced back to Marx. More recently, it gained prominence and "respectability" in academic circles through the pioneering work of Berle and Means on the implications of the modern corporation:[1]

> The typical business unit of the 19th century was owned by individuals or small groups; was managed by them or their appointees; and was, in the main, limited in size by the personal wealth of the individuals in control. These units have been supplanted in ever greater measure by great aggregations in which tens and even hundreds of thousands of workers and property worth hundreds of millions of dollars . . . are combined through the corporate mechanism. . . .

The trend, Berle and Means believed, was likely to continue: ". . . Every indication seems to be that the system will move forward to proportions which would stagger imagination today. . . ."[2]

At the other end of the spectrum is the view that concentration has not increased since the turn of the century, and that both technology and the dynamics of business are constantly opening up new opportunities for small business. Great corporations exist, of course, but their relative importance in the economy has not increased over the last fifty years. "The extent of concentration shows no tendency to grow," writes Professor Adelman, "and it may possibly be declining. Any tendency either way, if it does exist, must be at the pace of a glacial drift."[3] And Mr. Lilienthal points out that "one of the most attractive aspects of modern Big Business is that it creates opportunities previously nonexistent for a multitude of small business enterprises. . . ."[4]

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[1] A. A. BERLE, JR. & G. C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 2-3 (1932).

[2] *Id.* at 1.

[3] Adelman, *The Measurement of Industrial Concentration*, 33 REV. ECON. & STAT. 269, 295 (1951).

[4] DAVID E. LILIENTHAL, BIG BUSINESS: A NEW ERA x (1953).

In recent years, a good deal of research has been undertaken on the facts that are needed to determine which of these views is more nearly correct. The writer will try to answer this question by reviewing the statistical findings. A concluding section will outline the broader implications of the statistical trends that are observed.

I

SMALL BUSINESS IN TODAY'S ECONOMY

According to the estimates of the Department of Commerce, there are today about 4,300,000 business firms in the United States or twenty-five to twenty-six per 1,000 population.[5] This figure excludes agriculture and the independent professions, which together account for about the same number of "business units."[6] The Department of Commerce counts corporate subsidiaries as distinct business units, but the appropriate figure on a "consolidated" basis is not likely to differ by as much as 100,000.[7] It may thus be estimated that including agriculture and the professions, there are roughly 8,500,000 business firms, or fifty-one per 1,000 of population.

The vast majority of these firms are "small business" within any reasonable definition of this term. In 1947, ninety-nine per cent of the business units, by Department of Commerce count, had less than 100 employes, and ninety-five per cent had less than twenty employees.[8] It is safe to assume that if firms are counted on a "consolidated" basis, the proportion of small firms is even higher. If agriculture and the professions are included, the proportion is obviously much higher still.

Table one shows that the predominance of small firms in the business population is characteristic of all industry groups. Firms with less than 100 employees constitute ninety-nine per cent of all firms, or more, in retail and wholesale trade, service industries, the finance group, and construction. The lowest percentage is that for manufacturing, and even here, ninety-four per cent of the firms have less than 100 employees.

There are, of course, no uniformly accepted standards as to what constitutes "small business," and many of those concerned with the problem would agree that size, measured on some absolute scale, should not be the only criterion. Most definitions, implicit and explicit, would, however, include a good many firms with *over*

[5] Survey of Current Business, Jan. 1958, p. 6.

[6] In 1954, there were 3,900,000 farms in the United States (excluding "residential" farms, with sales of farm products of less than $250 per year). Only 20,000 were operated by hired managers. In 1955, there were 3,800,000 self-employed workers in agriculture. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 624, 630, 212 (1957) [hereinafter cited as STATISTICAL ABSTRACT].

The Census lists 600,000 self-employed professionals, 4 U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, 1950 CENSUS OF POPULATION, SPECIAL REPORTS pt. 1, c. B, table 12, 1B-123 (1956); but many of these are members of partnerships. Data for 1954, published by the American Bar Foundation, suggest that about one-third of the lawyers in private practice are in partnerships. STATISTICAL ABSTRACT 148.

[7] U.S. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, 1954, CORPORATION INCOME TAX RETURNS 123 (1957), show returns for 10,416 subsidiaries, for a year in which 80 per cent stock ownership was sufficient to permit the filing of a consolidated return. FTC, A LIST OF 1000 LARGE MANUFACTURING COMPANIES AND THEIR SUBSIDIARIES, 1948 (1951) suggests that cases of controlling ownership of less than 80 per cent are *relatively* infrequent.

[8] Survey of Current Business, April 1955, p. 19.

100 employees in the "small-business" category. A review of legislative and administrative practice suggests that "cut-offs" of 250 or 500 employees have been frequently used.[9]

TABLE I

DISTRIBUTION OF BUSINESS FIRMS BY INDUSTRY GROUP, 1951

INDUSTRY GROUP	NUMBER OF FIRMS (THOUSANDS)	PERCENTAGE OF FIRMS WITH LESS THAN 100 EMPLOYEES
All Industries	4067	99
Retail Trade	1821	a
Service Industries	733	a
Finance, Insurance, Real Estate	327	99
Contract Construction	377	99
Manufacturing	323	94
Wholesale Trade	269	99
Transportation and Public Utilities	181	98
Mining, Quarrying, Oil Wells	37	97

[a] More than 99.5 per cent.

SOURCE: Survey of Current Business, May 1954, pp. 18, 23.

We can, therefore, conclude that well over ninety-nine per cent of all firms, or between twenty-five and twenty-six per 1,000 of population, are "small business," even if we leave out of consideration agriculture and the professions. This finding gives us a standard by which to judge the trend in concentration.

The vast majority of business firms are not only small, they are also unincorporated. At a time when, according to the prediction of Berle and Means, the corporate system should have pretty well taken over the whole economy, eighty-seven per cent of all business firms, by Department of Commerce definition, are unincorporated;[10] and the proportion of unincorporated units in agriculture and the professions is, of course, much higher. The proportion of incorporated firms is highly correlated with firm size. In 1947, eighty-three per cent of the firms with 100 employees or more were incorporated, but less than eleven per cent of the smaller firms were.[11]

The economic importance of small firms is, of course, not adequately measured by their number. The major feature of the size structure of business firms is its extreme inequality, and in terms of any measure of size, small firms are much less important than their numerical predominance would suggest. Firms with 100 employees or more, which constitute, as has been shown, only one per cent of the business population as defined by the Department of Commerce, nevertheless account

[9] House Select Committee on Small Business, *Review of Small Business*, H.R. REP. No. 2513, 82d Cong., 2d Sess. 2-4 (1952).

[10] Survey of Current Business, April 1955, p. 15.

[11] *Id.* at 19.

for sixty per cent of the total employment in this sector. The small firms, which comprise ninety-nine per cent of the total, thus account for only forty per cent of employment.[12] While the inequality of firm size varies a good deal from one industry group to another, it is very high in all of them. According to the Department of Commerce estimates, the top *one per cent* of firms in each industry group account for the following percentages of employment:[13]

Transportation and Public Utilities		79%
Manufacturing		56%
Finance, Insurance, Real Estate		55%
Mining and Quarrying		52%
Retail Trade		43%
Service Industries		39%
Contract Construction		35%
Wholesale Trade		34%
Manufacturing Subgroups		
Highest		
	Transportation Equipment	74%
	Chemicals and Allied Products	67%
	Petroleum and Coal Products	65%
Lowest		
	Textile Mill Products	25%
	Paper and Products	25%
	Apparel and Related Products	24%

The degree of inequality is actually greater than these figures indicate, since a complete consolidation of the figures for corporate subsidiaries with those of their parent companies would undoubtedly raise the share of the "top one per cent." In the fields of trade, services, and construction (as well as agriculture and the professions), small firms account for the greater part of employment. In the other sectors of the economy, however, the bulk of employment is controlled by "large" firms. It is this great inequality of size that makes it possible to claim, at one and the same time, that the typical business firm is very small, and that the economy is dominated by large firms.

The relative importance of small business in the economy can also be investigated by examining the relative frequency of opportunities for self-employment. The Census of 1950 shows 9,400,000 self-employed workers out of a total number of 55,800,000, a proportion of seventeen per cent. This figure excludes self-employed managers of privately-held corporations, but a correction on this account would not raise the figure by as much as one percentage point. If farmers, farm managers, and farm laborers are excluded, the self-employed number 5,200,000 out of a total of 49,100,000 workers, or a proportion of eleven per cent. If professionals are also excluded, the figure is just over ten per cent. Thus, even in the nonagricultural

[12] Survey of Current Business, May 1954, p. 18. (Data for 1946-51.)
[13] *Id.* at 20. (Data for 1951.)

sector of the economy, outlets for the small businessman constitute more than one-tenth of employment opportunities.[14]

II

Trends in the Importance of Small Business

Since at least ninety-nine per cent of all business firms are "small," large changes in the total number of firms can be taken as indicators of changes in the small-business population. According to the Department of Commerce estimates, the number of business firms, excluding agriculture and the professions, rose from about 1,500,000 at the turn of the century to 3,000,000 in 1929, 3,300,000 in 1940, 4,000,000 in 1949, and 4,300,000 in 1957. The rising trend was interrupted only during the Depression of the 'thirties, when the number of manufacturing firms shrank severely, and during World War II, when the main decline was in retail firms. The low points were 2,800,000 in 1933 and 2,900,000 in 1943.

Per 1,000 of population, the number of small firms rose from about twenty-one at the turn of the century to twenty-five in 1929 and 1940, and twenty-seven in 1949. Since then, it has fallen slightly to twenty-five in 1957. Thus, the number of small business outlets in the nonagricultural sector has increased, per head of population, since the turn of the century and has not declined below the level of the 'twenties.[15]

In agriculture, the trend has been very different. The number of farms (all types) fell from 6,400,000 in 1910 and 1920 to 6,300,000 in 1930, 6,100,000 in 1940, 5,400,000 in 1950, and 4,800,000 in 1954. There has been, thus, a drastic decline since the interwar period, and the decline in relation to population is of longer standing. Per 1,000 of population, the number of farms fell from sixty-nine in 1910 to sixty-one in 1920, fifty-one in 1930, thirty-six in 1950, and thirty in 1954.[16]

If the results for the agricultural and nonagricultural sectors of the economy are combined, it is clear that in relation to population, the number of small "firms" has declined over the last fifty years. It is equally clear, however, that this outcome is entirely due to the decline in the relative importance of agriculture, combined with a trend towards increased concentration in this sector. In the nonagricultural branch of the economy, the numerical importance of small business has increased since 1900, and it has at least held its own since 1929.

It may, however, be rash to interpret the increase in the relative number of small firms in the nonagricultural sector as representing an increase in significant opportunities for the small businessman. The average life span of a small business is notoriously short, mainly owing to the very high rate of "infant mortality." If the life expectancy of small firms has decreased significantly over the long run, the

[14] 4 U.S. Bureau of the Census, *op. cit. supra* note 6, pt. 1, c. B, table 12, 1B-123. The *total* number of corporations in 1950 was 500,000. Survey of Current Business, April 1955, p. 18. If we count one self-employed businessman for each corporation, which is most likely too much, the percentage would rise by just one point.

[15] Survey of Current Business, Jan. 1954, p. 12; *id.*, Jan. 1958, p. 6.

[16] Statistical Abstract 5, 630.

rise in the relative number of firms would indicate a rise in the relative number of optimists rather than opportunities. The rate of business turnover should, therefore, be investigated.

There is no reliable historical information on a comprehensive basis regarding the rate of turnover among small firms. Some light is, however, thrown on this matter by the records of Dun and Bradstreet. Their listing of business firms, while incomplete, appears to cover between one-half and two-thirds of the number estimated by the Department of Commerce. Hence, we can be sure that at least ninety-eight per cent of their firms are "small." The number of firm names annually deleted from their list gives an indication of the rate of turnover, although it reflects transfers of ownership and disappearance of a firm through merger, as well as discontinued businesses. The percentage of "deletions" in the Dun and Bradstreet listing averaged between twenty and twenty-one per cent in the first three decades of the century, but fell to eighteen per cent in the late 'thirties and seventeen per cent in the 'forties.[17]

For the 'forties and 'fifties, Department of Commerce estimates are available. The percentage of firms "discontinued" and "transferred" (roughly comparable to the Dun and Bradstreet "deletions") was sixteen per cent in 1950-56. Omitting transfers, the percentage of firms discontinued was eight per cent in the 'forties and 7.6 per cent in 1950-56.[18]

The limited evidence that is available thus suggests that there has not been any long-run tendency towards increased mortality among small firms. In fact, the opposite trend is suggested by the figures. We may conclude that in the nonagricultural sector of the economy, the opportunities for small business have not contracted, but have, on the contrary, tended to expand over the last fifty years. This expansion has not, however, been sufficient to offset the decline in the number of farms.

III

THE TREND IN CONCENTRATION

It is evident that whatever the trend in concentration may have been in the twentieth century, it has not had the effect of reducing the opportunities for small business in the nonagricultural sector of the economy. This finding does not, however, render it superfluous to investigate the trend in concentration. The degree to which economic activity is concentrated in large firms is obviously a very important aspect of the environment in which small business operates. Small firms deal with large firms as suppliers, customers, and competitors. Any change in the inequality of size or in the number of alternative sources or outlets facing the small firm is bound to affect the way in which small business operates and the results of its operations.

[17] Computed from data in NAM, BUSINESS SIZE AND THE PUBLIC INTEREST 17 (1949).

[18] Computed from data in Survey of Current Business, April 1955, p. 20; *id.*, Jan. 1954, p. 13; *id.*, Jan. 1958, p. 6.

The long-run trend in concentration has, in recent years, been the subject of a lively controversy in academic circles. In the 'thirties, the statistical investigations of Gardiner C. Means appeared to support the theory of a trend toward increasing concentration, and his opponents were mainly concerned to attack the reliability of his figures—always an easy task in this field.[19] Since the war, new statistical studies suggest that in important sectors of the economy, concentration is more likely to have declined over the last fifty years, and it is now the protagonists of the theory of increasing concentration who attack the reliability of the statistics.[20]

The subject is controversial not only because the statistical information is inadequate and unreliable, but also because there is no agreement, and often no clarity, as to what is meant by "concentration" and how it should be measured. In this paper, concentration will be discussed in two senses: "Absolute" concentration means the degree to which a small *number* of firms accounts for a large sector of the economy, industry, or product under discussion. "Relative" concentration, or "inequality," means the degree to which a small *percentage* of the firms concerned accounts for a large proportion of the economy, industry, or product. The terms "concentration" and "inequality," used without qualifying adjectives, will mean "absolute" and "relative" concentration, respectively.

The room for controversy is further enlarged by the fact that there is no unique way of measuring concentration or inequality. Concentration is often measured by the percentage of an industry's output accounted for by the four, eight, or twenty largest firms. But in a given period, an industry may become less concentrated in terms of the four largest firms and more concentrated in terms of the eight largest. Inequality can be measured by the percentage of, say, output controlled by the largest one per cent, five per cent, or ten per cent of the firms, as well as by a "coefficient of variation," a "Gini ratio," a "Pareto coefficient," and other fruits of the statistician's imagination. In the comparison of different industries or periods of time, it is quite possible for the verdict of these measures to disagree.[21]

Often, a particular development may have opposite effects on concentration and inequality. The recent mergers among the smaller automobile manufacturers left concentration unchanged, if measured in terms of the three largest firms, raised concentration in terms of four firms, and reduced the degree of inequality. Such a situation not only provides unlimited scope for controversy among those who discuss the trend in concentration without defining their terms, but also created a real

[19] See BERLE & MEANS, *op. cit. supra* note 1, c. 3; Crum, *On the Alleged Concentration of Economic Power*, 24 AM. ECON. REV. 69 (1934); Tucker, *Increasing Concentration of Business Not Supported by Statistical Evidence*, 48 THE ANNALIST 149 (1936); George, *Is Big Business Getting Bigger?*, Dun's Review, May 1939, pp. 28, 32.

[20] See G. W. NUTTER, THE EXTENT OF ENTERPRISE MONOPOLY IN THE UNITED STATES (1951); Adelman, *supra* note 3; Edwards, Stocking, George, Berle, *Four Comments on "The Measurement of Industrial Concentration,"* 34 REV. ECON. & STAT. 156, 161, 168, 172 (1952); Adelman, *A Rejoinder, id.* at 174, 356; Blair, *"The Measurement of Industrial Concentration": A Reply, id.* at 343.

[21] For a fuller discussion of problems involved in the measurement of concentration, see Rosenbluth, *Measures of Concentration*, in G. J. STIGLER (ED.), BUSINESS CONCENTRATION AND PRICE POLICY 57 (1955).

dilemma for antitrust policy, since competition was increased in a significant sense by the reduction in inequality and reduced by the increase in concentration.

Scope for controversy is further broadened by the variety of economic units for which concentration can be measured. Berle and Means studied the role of the 200 largest nonfinancial corporations in relation to all corporations, all "business wealth," and national wealth. Other studies have measured concentration within narrowly-defined industries or within broad industry classes. Obviously, the trend of concentration measured on an over-all basis may diverge from the trend in some sort of average of concentration levels measured within narrowly-defined industries. For our purposes, both bases of measurement are significant. For the study of the relations of small businesses with their competitors, the measurement of concentration within industries is appropriate. But the relations of small businesses with the suppliers of their materials, equipment, or credit and the purchasers of their products or services generally cut across industry lines.

Finally, there is, in theory at least, a considerable range of choice as to the units in which business size is to be measured for the purpose of studying concentration. Employment, value of output, net income, and assets have all been used; each of them involves a host of problems in the fields of measurement and valuation, and, again, it is theoretically quite possible for their verdicts to diverge.

If, in addition to all these difficulties, we consider the great paucity of relevant statistical information, it is not surprising that there has been controversy. What is, perhaps, surprising is that in relation to a number of important matters, there is agreement. We shall, therefore, start by considering those aspects of the trend in concentration that are not in dispute.

The first important point of agreement is that the economy emerged from the merger movement of the end of the nineteenth century with a very high degree of concentration in many important economic sectors. A recent survey of the literature on mergers sums it up thus:[22]

> The early combination movement . . . was of extraordinary social and economic importance. Historians have recorded it as an era and economists consider it the period when the pattern of concentration characteristic of twentieth-century American business formed and matured. . . . Of 92 large mergers studied by Moody, 78 controlled 50 per cent or more of the total output of the industry. . . . In the steel, tobacco products, petroleum refining, sugar refining, nonferrous metal smelting, shoe machinery, typewriter and other industries, it is quite clear that mergers transformed oligopolistic or competitive markets into markets dominated by partial monopolists. . . .

Many important aspects of this wave of mergers are still in dispute. There is a disagreement regarding the relative importance of the economies of mass production, the expectation of monopoly positions, and the search for "promoter's profit" in the motivation of the organizers of the giant combinations. There is also disagreement as to the extent to which *monopoly* positions were actually attained. But

[22] Markham, *Survey of the Evidence and Findings on Mergers*, in *id.* at 155, 158.

there is no disagreement about the fact that concentration and inequality of firm size, for the economy as a whole and its major sectors, increased decisively.

These changes in the business size structure radically transformed the problems confronting small firms, which were subjected to a variety of pressures from their larger brethren. Even before the "major" merger wave of 1896-1903, farmers—the largest class of small businessmen—were reacting in the political field against their increasing dependence on the large railway companies for transportation, on manufacturing trusts for their equipment, and on giant food-handling and processing firms for their markets. The early state antitrust laws, the Sherman Act,[23] and the Interstate Commerce Act[24] can be seen as the politicians' response to agrarian discontent. With the subsequent spread of concentration by merger throughout the manufacturing industries, as well as metal-mining and public utilities, the numerous small businessmen in manufacturing and retailing felt the pressure. The use of concentrated buying power to secure discriminatory prices from suppliers or railways, the practice of local price discrimination in selling to undermine a small competitor, selling below cost to eliminate a competitor, and all the other "unfair" competitive practices that were revealed in investigations and court proceedings before World War I (and repeatedly since that time) were all essentially devices used by the large against the small. They were "good business" only in a context of great inequality of market power and financial resources. The agitation against them, which led to the Clayton Act[25] and the Federal Trade Commission Act,[26] owes its success to the political weight of small business.

The second point on which there is agreement is that there has been wide diversity in the trends displayed by different industries since that great merger wave. It is easy to find important examples of increasing concentration. The automobile industry emerged from the early period of consolidation with the three leading firms accounting for forty-two per cent of car production. This figure is for 1909, one year after the General Motors merger. By 1920, the three largest firms accounted for seventy-one per cent of output, as a result of the spectacular success of Ford's mass production technique, which raised the share of this company alone to forty-nine per cent. After the Chrysler merger in 1925, the share of the three largest firms continued to rise, although Ford's share declined. On the basis of new car registrations, the three largest firms accounted for seventy-two per cent in 1925, eighty-three per cent in 1930, and ninety per cent in 1938.[27] The proportion was lower immediately after the war, but had reached ninety-five per cent by 1955.[28]

[23] 26 STAT. 209-10 (1890), as amended, 15 U.S.C. §§ 1-7 (1952).

[24] 24 STAT. 379 (1887), as amended, 49 U.S.C. §§ 1-27, 41-43, 301-27 (1952).

[25] 38 STAT. 730 (1914), 15 U.S.C. §§ 11-27 (1952).

[26] 38 STAT. 717 (1914), as amended, 15 U.S.C. §§ 41-58 (1952).

[27] WILLARD L. THORP, WALTER F. CROWDER, AND ASSOCIATES, THE STRUCTURE OF INDUSTRY 244 (TNEC Monograph No. 27, 1941).

[28] FTC, REPORT ON INDUSTRIAL CONCENTRATION AND PRODUCT DIVERSIFICATION IN THE 1000 LARGEST MANUFACTURING COMPANIES 113 (1957).

Other examples of large industries with increasing concentration, at least in the last twenty years, are the brewing industry, where the share of output of the eight largest firms rose from seventeen per cent in 1935 to forty-one per cent in 1954; and the flour-milling industry, in which the eight largest firms accounted for thirty-seven per cent of output in 1935 and fifty-two per cent in 1954.[29] In copper production, the share of the four leading producers fell from seventy-six per cent in 1890 to thirty-nine per cent in 1920. Subsequently, however, concentration increased again very rapidly, and the four leading producers accounted for seventy-six per cent of copper output in 1930 and eighty-two per cent in 1937. In 1954, the four leading producers accounted for ninety-four per cent of the output of copper smelter products.[30]

On the other hand, we can find many important industries in which concentration has continued to decline from the high levels reached at the turn of the century. For example, the four largest meat-packing firms were reported to control fifty per cent of the industry or more at the turn of the century.[31] By 1947, the share of the four largest had fallen to forty-one per cent, and by 1954, to thirty-nine per cent.[32] The Standard Oil trust, before its dissolution by court decree, controlled the marketing of about eighty per cent of refinery production. As a result of the dissolution in 1911 and the entry of new firms, concentration declined considerably, and in 1938, the twenty leading firms held only seventy-three per cent of refinery capacity, and the four leading firms held twenty-seven per cent.[33] A further decline in concentration is indicated by the data for the value of output of the refinery industry: concentration of output in the four largest firms fell from thirty-eight per cent in 1935 to thirty-three per cent in 1954.[34]

An analysis of concentration trends in 123 manufacturing industries shows that in the nineteen years, 1935-54, concentration of output in the four largest firms increased by ten percentage points or more in fourteen per cent of the cases, and decreased by ten percentage points or more in twenty-three per cent of the cases. Increases of five percentage points or more accounted for just under one-third of the cases, and decreases of five percentage points or more for just over one-third.[35] It is clear, therefore, that any average of concentration trends within industries represents the net effect of conflicting tendencies, and that there has been no *typical* pattern of increase or decrease. It is not surprising, then, that estimates of the "average" increase or decrease in concentration within industries have been small.

The third point on which there is agreement, at least among the postwar investigators of the trend in concentration, is that any change in absolute "over-all"

[29] STAFF OF SUBCOMMITTEE ON ANTITRUST AND MONOPOLY, SENATE COMM. ON THE JUDICIARY, 85th CONG., 1st SESS., CONCENTRATION IN AMERICAN INDUSTRY 221 (Comm. Print 1957) [hereinafter cited as CONCENTRATION IN AMERICAN INDUSTRY].

[30] THORP & CROWDER, *op. cit. supra* note 27, at 249; CONCENTRATION IN AMERICAN INDUSTRY 83.

[31] NUTTER, *op. cit. supra* note 20, at 130.

[32] CONCENTRATION IN AMERICAN INDUSTRY 196.

[33] H. L. PURDY, M. L. LINDAHL, & W. A. CARTER, CORPORATE CONCENTRATION AND PUBLIC POLICY 253, 258 (1950).

[34] CONCENTRATION IN AMERICAN INDUSTRY 207.

[35] *Id.* at 35.

concentration, for the economy as a whole or its major sectors, has probably been slight. It is safe to assume that a *strong* trend of increasing or decreasing concentration would have been less open to controversy.

A review of some of the statistical information on over-all concentration will indicate the order of magnitude of the possible changes. The long-run trend in manufacturing is indicated by Kaplan's data on the role of the 100 largest "industrial" corporations. As a percentage of the corresponding total for all industrial corporations, the total assets of the 100 largest amounted to 24.6 per cent in 1909, 25.5 per cent in 1929, and 26.7 per cent in 1948.[36]

For the latter part of this period, more detailed information is available which is summarized in table two. These figures suggest that in the last twenty years, over-all concentration in manufacturing has not changed much, although there may have been a slight increase in the last decade.

In the public utilities field, never a significant area for "small business," concentration increased up to the 'thirties, largely as a result of the "second merger wave" of the late 'twenties. That is why Means' figures for the "200 largest nonfinancial corporations," *including* railways and public utilities, showed an increase in concentration. In terms of total "net" assets (excluding investment in other corporations) and in relation to all "nonfinancial" corporations, concentration in the 200 largest rose from about one-third in 1909 to about one-half in 1929, and fifty-five per cent in 1933.[37] Subsequently, however, the public utilities industry has been "deconcentrated" under the provisions of the Public Utility Holding Company Act of 1935.[38]

In the transportation sector, there has been a steady increase of concentration in the railway branch; the number of operating railway companies fell from 1306 in 1910 to 775 in 1930, and 471 in 1950.[39] This development has, however, been accompanied (and, indeed, in part caused) by the rapid expansion of road, and later, air transportation; and the net effect has undoubtedly been a decline in concentration for the sector as a whole. By the beginning of World War II, the railways' share of intercity domestic freight traffic (in ton-miles) was less than two-thirds. After a brief upswing in the war, it fell to fifty-eight per cent in 1950, and below fifty per cent in 1954. The share of road transport rose from nine per cent in 1939 to nineteen per cent in 1954; and the share of oil pipelines from ten per cent in 1939 to sixteen per cent in 1954.[40]

Complaints of increasing concentration in the retail field were frequent in the 'twenties and 'thirties and were a prominent feature of the political campaign that

[36] A. D. H. KAPLAN, BIG ENTERPRISE IN A COMPETITIVE SYSTEM 126 (1954). "Industrials" exclude financial, railway, and public utility corporations. Corporations in mining, construction, trade, and services are included, but manufacturing accounts for about ⅔ of the total "industrial" assets.

[37] NAT'L RESOURCES COMM., THE STRUCTURE OF THE AMERICAN ECONOMY pt. I, at 106-07 (1939).

[38] 49 STAT. 803, 15 U.S.C. §§ 79-79z-6 (1952).

[39] STATISTICAL ABSTRACT 561.

[40] *Id.* at 559.

culminated in the Miller-Tydings Act.[41] Statistics available since 1929 suggest that there was some justification for these claims; the percentage of retail sales accounted for by chain stores and mail-order houses rose from twenty-one per cent in 1929 to twenty-seven per cent in 1933, and had probably risen in the preceding decade. Since the 'thirties, however, there does not seem to have been any rising trend in this percentage; it was twenty-three per cent in 1939 and twenty-two per cent in 1951. Since that latter year, a new statistical series based on a narrower definition of "chain stores" shows a slight increase in the corresponding percentage from eighteen per cent in 1951 to nineteen per cent in 1956. The increase has been somewhat more pronounced in the grocery field, where the chain stores' percentage of business rose from thirty-five per cent in 1951 to thirty-nine per cent in 1956.[42]

Agriculture is the only economic sector that provides clear evidence of a steady trend towards higher concentration. In 1920, the 217,200 largest farms (of a total of 6,400,000) accounted for thirty-four per cent of the acreage; and in 1940, only 100,500 farms accounted for the same percentage. By 1950, the 121,400 largest farms had forty-three per cent of the acreage. The number of farms diminished throughout this period, while the total acreage increased.[43]

No comprehensive information on the trend in concentration is readily available for the other sectors of the economy. The main nonfinancial sectors—construction,

TABLE II
CONCENTRATION IN MANUFACTURING

A. Percentage of Value of Output

	1935	1937	1950
Largest 50 Firms	26	28	27
Largest 100 Firms	32	34	33
Largest 200 Firms	38	41	40.5

B. Percentage of Value Added by Manufacture

	1935	1937	1947	1954
Largest 50 Firms	19	20[a]	17	23
Largest 100 Firms	25	26[a]	23	30
Largest 200 Firms	31[a]	32[a]	30	37

[a] Ranking of firms based on value of output; hence the percentage may be slightly understated.

SOURCES: A. FTC, REPORT ON CHANGES IN CONCENTRATION IN MANUFACTURING, 1935 TO 1947, AND 1950, at 17, 21 (1954); WILLARD L. THORP, WALTER F. CROWDER, AND ASSOCIATES, THE STRUCTURE OF INDUSTRY 715 (TNEC Monograph No. 27, 1941).

B. STAFF OF SUBCOMMITTEE ON ANTITRUST AND MONOPOLY, SENATE COMM. ON THE JUDICIARY, 85th CONG., 2d SESS., CONCENTRATION IN AMERICAN INDUSTRY 11 (Comm. Print 1957); WILLARD L. THORP, WALTER F. CROWDER, AND ASSOCIATES, THE STRUCTURE OF INDUSTRY 583, 715 (TNEC Monograph No. 27, 1941); NAT'L RESOURCES COMM., THE STRUCTURE OF THE AMERICAN ECONOMY pt. 1, 270 (1939).

[41] 50 STAT. 693 (1937), 15 U.S.C. § 1 (1952).

[42] STATISTICAL ABSTRACT 838, 849; Adelman, *The Measurement of Industrial Concentration*, 33 REV. ECON. & STAT. 269, 293 (1951).

[43] STATISTICAL ABSTRACT 622.

mining, services, and wholesale trade—are, of course, included in Kaplan's data for the leading "industrial" corporations cited above.

The financial sector has generally been ignored by the participants in the recent debate on the trend in concentration. Yet, for banking, sufficiently reliable information is available, which indicates a decline in concentration to about 1920, a definite rise to 1940, and some decline thereafter. Between 1900 and 1920, the number of banks rose from 10,382 to 30,139, and the percentage of total loans and investments held by the twenty largest banks fell from 15.1 per cent to 13.8 per cent. In 1920, fifty-nine per cent of all commercial banks had a capital stock of less than $50,000 and could thus be classified as "small business." Thereafter, under the impact of mergers and failures, concentration increased rapidly. By 1930, the number of banks had fallen to 24,079, and the percentage of loans and investments concentrated in the twenty largest banks had risen to 24.8 per cent. Following the widespread failures of the early 'thirties, the number of active banks fell to 16,053 in 1935.[44] Concentration of deposits in the 100 largest commercial banks rose from forty-six per cent in 1930 to fifty-five per cent in 1935, and fifty-eight per cent in 1940.[45]

In the 'forties and the 'fifties, the number of banks has continued to shrink—to 14,666 in 1950 and 14,103 in 1957.[46] Nevertheless, concentration appears to have declined from the peak level reached in 1940. In 1948, the 100 largest commercial banks held only forty-five per cent of the deposits of all commercial banks. Since then, the proportion has increased slightly, but not enough to indicate a trend; in 1955, it was still only forty-seven per cent.[47]

The figures given here understate the degree of concentration in banking, owing to the existence of groups of banks under common control. The number of such groups and of banks under their control rose rapidly in the 'twenties. In 1925, there were 134 groups or chains operating 933 banks, while in 1929, there were 331 groups with 1921 banks. By 1952, the number of banks in groups or chains had fallen to 909, largely owing to an increase in the number of states permitting branch banking.[48] Thus, the decline of concentration of control since the 'thirties has probably been greater than the decline in concentration in banks considered as separate units.

This survey of concentration trends can now be summed up. The trend in agriculture has followed the pattern asserted by the theory of increasing concentration, and the number of small firms has declined. In the nonagricultural sector, however, the number of small firms has increased, and concentration in individual narrowly-defined industries has shown a variety of patterns. Over-all concentration in the

[44] A. L. BERNSTEIN (ED.), BIG BUSINESS, ITS GROWTH AND PLACE 83, 91, 92 (1937); and STATISTICAL ABSTRACT 438.

[45] SELECT COMMITTEE ON SMALL BUSINESS OF THE SENATE, 82d CONG., 2d SESS., CONCENTRATION OF BANKING IN THE UNITED STATES 16 (Comm. Print No. 7, 1952) [hereinafter cited as CONCENTRATION OF BANKING].

[46] 88TH ANN. REPORT OF THE COMPTROLLER OF THE CURRENCY 14 (1951); *id.* 95th, at 19-20 (1958).

[47] CONCENTRATION OF BANKING 16; *Hearings Before the Committee on Banking and Currency of the Senate on Regulation of Bank Mergers,* 84th Cong., 2d Sess. 17 (1956).

[48] See P. T. HOGENSON, THE ECONOMICS OF GROUP BANKING, 13, 15-17 (1955); CONCENTRATION OF BANKING 7, 8.

major branches for which information is available does not seem to have changed much since the pattern of high concentration was established at the turn of the century. If a statement one way or the other must be made on the basis of the figures we have examined, some increase over the long run is suggested in manufacturing, distribution, and banking; but, taking into account the difficulties discussed at the beginning of this section, one cannot say that the data are inconsistent with the assumption that there has been no change, or even a slight decline, in over-all concentration. There has certainly not been any strong decline or, for that matter, any strong increase.

Coming back to the controversy outlined in the introduction, it looks as if the prize should be awarded to the opponents of the theory of increasing concentration. Concentration, over-all, has *not* increased (greatly, at any rate) if we ignore agriculture (which is common practice), and the number of small firms definitely *has* increased (again, if we ignore agriculture). There is, however, an important corollary of these results that is often overlooked. If the number of firms in the nonagricultural sector has increased significantly, and the degree of absolute concentration has not declined greatly, then the degree of relative concentration or inequality must (this is a mathematical "must") have increased. If the share of the largest 200 firms, say, has not changed, and the number of firms has increased, this share is now held by a smaller percentage of the firms. Or, putting the matter differently, the ratio of the average size of the largest 200 firms to the average size of all firms has increased. As far as the problems confronting small business are concerned, this increase in inequality of size, which has continued throughout the period reviewed here, is, of course, very important. The large firms have grown larger, and the small firms more numerous.

IV

Why Small Business Survives

It is, perhaps, surprising that the same environment that has encouraged the growth of large firms has also been favorable to the multiplication of small firms. At any rate, it is surprising to those whom a training in economic theory has conditioned to consider these developments as incompatible.

Two related types of development have, over the last fifty years, repeatedly created and expanded opportunities for small business. First, technological progress has developed new techniques and products that could be profitably exploited by small business. Secondly, the trend has been reinforced by a tendency for large firms to free themselves of functions that could be economically performed by the small.

Examples of these trends have often been discussed. On the purely technological side, the advent of electric power has freed the firm from the heavy overhead involved in generating its own power; has increased the range of economical plant locations, thus lowering initial costs; and has made possible the development of

efficient low-capacity machinery. The light metals and plastic materials that are becoming increasingly important have proved suitable for secondary fabrication in small-scale plants. Road transport not only has opened opportunities for small firms in trucking and bus transportation, but has also contributed to the scattering of plant locations. Many developments in processing technique have favored small firms.[49] Thus, the very common assumption that technological progress must involve increasing economies of scale is not correct.

These technological trends have been reinforced by opportunities for small business created by the growth of large firms. Small business has been driven out of the manufacture of automobiles, but has found greater opportunities in the sale of automobiles. Conversely, supermarket chains and mail-order houses have provided outlets for a host of small manufacturers and new classes of wholesalers. Such new types of small business as the advertising agency, management consultant, and research service in marketing, economics, sociology, and psychology sell their services to the large corporation. Thus, many small businesses exist today which would have no place in a small-business economy. They depend on inequality of size for their existence. Thus, to some extent, small firms have grown more numerous *because* large firms have grown larger.

V

IMPLICATIONS

The role of small business and the problems confronting it in an economy marked by extreme and growing inequality of firm size are quite different from those that would arise in a small-business economy. Many small businesses today are little more than appendages of the large. An automobile dealer who obtains all his stock from one manufacturer, a gasoline dealer who obtains not only his supplies, but also his financing and capital equipment from one firm, a manufacturer who sells his whole output to one mail-order house, an advertising agency or consulting service that gets ninety-eight per cent of its business from one firm—all these can hardly be regarded as "independent businessmen" in the traditional sense. In the less extreme cases, the small businessman is faced with high concentration in the sources of his materials, his equipment, or his financing, or high concentration among the buyers of his product or service. The resulting inequality of bargaining power means a loss of independence. When a small businessman is in competition with larger rivals, there is likely to be price discrimination in their favor and discrimination in the allocation of scarce supplies and in financing. In a world in which contracts with government agencies are of increasing importance, large business tends to get the contracts and small business the subcontracts. As the trend has been towards increasing inequality of size, the problems arising from inequality are likely to have become more widespread and more serious.

[49] See Blair, *Technology and Size*, 38 AM. ECON. REV. 121 (1948). The examples cited are based on this article.

A good deal of legislative effort has gone into attempts to protect small business against the consequences of inequality and concentration. Some, such as the antitrust laws and the attempts to reduce discrimination in financing, tend to promote competition and economic efficiency. Others, such as the legalization of resale price maintenance and the agricultural price supports, marketing quotas, and acreage allotments, have the opposite effect. This is not the place for an evaluation of these policies, but one comment may, perhaps, be permitted. The traditional notion that small business is "a good thing," quite apart from the question of competitive efficiency, is based on certain political, psychological, and sociological assumptions. The diffusion of economic power in a society of small businessmen has been regarded as a safeguard against the concentration of political power. The training in the exercise of independent judgment and in reliance on one's own decisions has been considered good for the soul. The widespread ownership of property and interest in the continuity of business relations has been seen as an element of social stability. It is necessary to re-examine such assumptions as these in the context of the actual structure and functioning of the business economy.

CO-OPERATIVES AS AN AID TO SMALL BUSINESS IN GERMANY

Gerhard Weisser* and Bertel Fassnacht†

The problem of competition is the same for small business in West Germany as in all industrial countries with a competitive economy. Small firms feel the weakness of their bargaining power in competition with large firms in many industries and have, therefore, come to concentrate their activity more in fields of specialized production and services. There is, however, a difference in the attempts that have been made to overcome this weakness. These attempts have had some success and have, therefore, set a pattern for a number of other countries, notably in central and northern Europe. In describing them here, we are confining the discussion to manufacturing, handicraft, and trade, since agriculture has special problems in any industrial country.

The traditional stronghold of small enterprise in Germany and its *Mittelstand* class of proprietors in Germany has been retailing and, with a stronger corporate tradition, handicraft. In these fields, small business has been able to retain considerable importance, even after a decline during the nineteenth century.

Handicraft firms differ from small industrial firms not necessarily in their method of production or in size, but in the kind of training required of the artisan, in conditions of entry into the trade as regulated by law, and in enrollment at the *Handwerkskammer*—their corporate administration. Such attributes of status cannot, however, conceal the fact that artisans are embedded in a competitive economy, with little protection against its effects. Table one shows that the total number of artisan firms, which had increased from 792,000 in 1939 to 864,000 in 1949, has fallen back to 752,000 by 1955, which is below the prewar level. At the same time, the number of persons employed in artisan firms has risen considerably, from 2,600,000 in 1939 to 3,600,000 in 1955. The trend towards a higher average number of persons employed per shop has been fairly even in the different branches of handicraft, but some groups show a marked variation from the general pattern: in the metalworking trades and in the glass, ceramic, and other trades (photography, musical instrument-makers, etc.), the number of artisan firms has shown an increase; whereas in woodworking and in textiles, clothing, and leather, the number of persons employed has decreased since 1949—in the case of the latter group, even to a figure below that of 1939.

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TABLE I

ARTISAN FIRMS AND THEIR EMPLOYMENT BY INDUSTRIAL GROUPS, 1939-55

Group	Artisan Firms			Persons Employed in Artisan Work (thousands)		
	1939	1949	1955	1939	1949	1955
Building	161	181	122	951	1,060	1,256
Metalworking	89	117	145	306	454	798
Woodworking	101	106	83	273	348	313
Textiles, Clothing, & Leather	242	272	199	433	571	412
Food	130	116	117	456	404	497
Laundry, Health & Beauty Service	59	58	63	163	184	263
Glass, Ceramic, & Other Groups	11	14	22	29	39	86
Total	792	864	752	2,610	3,060	3,625

SOURCE: STATISTISCHES JAHRBUCH FUR DIE BUNDESREPUBLIK DEUTSCHLAND 172-76 (1952); *id.* at 212-13 (1958).

TABLE II

ARTISAN FIRMS BY SIZE GROUPS, 1949-56

Size Group (persons employed)	Artisan Firms (thousands)		Percentage of Total		Percentage of Increase or Decrease in Number of Firms, 1949-56
	1949	1956	1949	1956	
1	315.1	249.7	36.5	33.2	− 21
2- 4	390.2	311.4	45.2	41.5	− 20
5- 9	111.4	124.1	12.9	16.5	+ 11
10-24	36.5	47.6	4.2	6.3	+ 31
25-49	7.0	12.1	0.8	1.6	+ 73
50-99	2.1	4.9	0.3	0.6	+126
100 and more	0.6	1.9	0.1	0.3	+223
Total	862.9	751.6	100	100	− 13

SOURCE: Kunz-Pfaff, *Die Großenklassen der Handwerksbetriebe nach der Zahl der Beschäftigten*, 6 WIRTSCHAFT UND STATISTIK 334 (1958).

The vast majority of artisan firms is still very small. Table two shows that in 1956, ninety-one per cent had less than ten persons employed, but that many of these firms headed by craftsmen have grown into larger size groups since 1949. The number of firms with less than five persons employed has decreased by one-fifth during this period. Many of these artisans who dropped out had probably entered the trade after the war and were not fully competent. Such an influx into self-employment occurs usually during postwar years and periods of economic crisis. When economic recovery increases job opportunities, many self-employed prefer the greater stability of a regular pay-check. This readjustment of handicraft has been brought about by competition from larger artisan firms whose number has grown at the same time. There have been 27,000 of them with more than fifty persons employed in 1949, but 68,000 in 1956. Elimination of small units has been

particularly drastic in the construction and painting trades, where about half of all artisan firms with less than five persons employed closed down during the same period; while in some other trades, notably automobile-repair, and upholstering and decorating, the number of even such small firms has risen considerably. The opportunity of shifting from one branch of handicraft to another, however, is practically nonexistent, on account of very rigid training requirements.

The other field in which small business has traditionally had a very strong position is retailing. Here, competition from large-scale enterprise in the form of chain stores and department stores—even though not as strong as in the United States—has had its effect upon the small independent retailer in recent decades. Consumers' co-operatives, with their price-lowering tendency, have grown again since the war and become another competitor, but have so far concentrated their activity mainly on food distribution. On the whole, however, small independent retailers have proved themselves adaptable to new conditions and have retained their share of the growing market, especially in groceries, where they do about three-quarters of all retail trade.

In the manufacturing industries, the dominant trend of development has been, for a long time, toward larger plants and a concentration of big enterprise. Opportunities for small business in specialized services and in production contracts with large firms have also grown at the same time; these have, however, not been sufficient to allow small firms, on the whole, to attain their proportional share of economic growth. The figures in table three illustrate what has happened from 1953 to 1955

TABLE III

INDUSTRIAL ESTABLISHMENTS (NONARTISAN) IN DIFFERENT SIZE GROUPS, 1953 AND 1955

Size Group (number of employees)	Establishments		Sales of Products in Billion DM during Month of September (DM 4.20=$1)		Percentage Increase of Sales, 1953-55
	1953	1955	1953	1955	
1- 9	41,619	43,034	0.30	0.34	13
10- 49	30,570	30,541	1.24	1.42	15
50- 99	8,605	9,163	1.03	1.24	20
100-199	4,980	5,615	1.26	1.58	25
200-499	3,509	3,998	2.22	2.78	25
500-999	1,059	1,259	1.62	2.25	39
1,000 and more	831	983	4.09	5.98	48
Total	91,173	94,034	11.76	15.59	33

SOURCE: STATISTISCHES JAHRBUCH FUR DIE BUNDESREPUBLIK DEUTSCHLAND 214-15 (1955); *id.* at 216-17 (1957). Later figures are not published.

in a period of over-all growth. Both the number of industrial establishments and the sales of products have increased in almost all size groups, so that the total number of establishments rose to 94,000. While the smaller and medium-sized shops have shown an increase of sales, this increase has, however, considerably lagged behind

the general average increase of thirty-three per cent. At the same time, the large establishments have increased their sales far above the average rate. There is, in these figures, a clear correlation between size and the rate of increase. Furthermore, it should be noted that these data refer to establishments (local units) only, and not to firms and combinations, so that they do not reveal the full extent of the process of concentration.

In some branches of manufacturing, small business has been able to retain a relatively strong position. These include woodworking, printing, the clothing industry, and dairies, all with an element of service. But the general impression given by these data is that in the manufacturing industry, just as in handicraft production and services, with its traditional prevalence of small workshops, the situation of small business has increasingly become more difficult.

Small enterprise has its definite limitations in relation to large-scale forms of enterprise. Much has been written about the economies of large-scale production, and it is clear that some branches of manufacturing have become quite unsuitable for small units. Small business leaders claim, however, that in the fields where small enterprise exists, it is not in production costs where its main disadvantage lies. They point to evidence of government discrimination against small business in Germany and claim that the tax system works in favor of big business. Under the policy of postwar reconstruction, this has certainly been the case. The sales tax, which constitutes a substantial portion of federal tax income, is levied at each level of transaction, and thus puts a premium on vertical integration of functions. Also, a large part of municipal taxes is raised as a payroll tax from firms and hits small business harder, because its type of specialization has led to a larger proportion of labor costs.

The main structural weakness of small enterprise, regardless of current tax policy and economic fluctuations, is in its market relations. Small firms are unable to obtain the same advantageous rates as larger firms do in their bulk purchases of raw materials. They cannot make use of the same techniques of large-scale marketing and advertising of products. Above all, they have especially serious shortcomings in the increasingly important field of finance. Small firms cannot, to the same extent, utilize market power for the technique of internal financing through the prices charged in a sellers' market. Their access to the capital market is more limited; they cannot offer securities sufficient for long-term bank credit; and where they do obtain credit, they find that the interest rate is higher for small loans than for bigger loans. To supplement their slender equity-capital, they often have to rely on short-term trade credit, which is a very expensive credit and tends to limit their freedom in purchasing. The disadvantages of small scale are equally apparent when a firm wants to ensure itself the services of expert personnel. Often, its size will not warrant the expense for full-time positions, and this factor, as well as the cost of apparatus, has made research for technological development almost exclusively a domain of large enterprise.

It is, however, a matter of great relevance whether or not an economy has a strong element of small enterprise. If a whole economy is dominated by large firms, controlled perhaps by a small number of influential stockholders, it will lack the greater elasticity and refreshing variety of smaller firms, with their opportunities for independent decision and responsibility. Often the inherent values of the position of self-employment are more highly regarded than the income that goes with it. People may be put to more productive use when employed in a large concern; national output and income may be increased in consequence; but the greater national welfare, with a variety of objects in view, need not at all coincide with maximum national income. When inherent cultural values are in danger of being sacrificed, then the objective of maximizing national income will be disputed. Concentration of economic power and the political influence which may result from it, are recognized to be dangers to cultural values that may lead to public concern and to restrictive government action.

Government action designed to protect the interests of small firms can easily build up a lasting system of privileges and lead to mere conservation of enterprises which would otherwise have adapted themselves to new competitive conditions. Such dependence upon the public can be avoided when preference is given to a policy that develops the competitive ability of small enterprise. It is based not on direct government action, but on the capacity of those concerned to help themselves. Small business can overcome many of its structural weaknesses by self-help, and it has, in Germany, a long tradition of successful co-operative effort to improve its position. Functions for which the individual firm is too small can be fulfilled very effectively by a unit with larger capacity, established by small firms on a co-operative basis. Such a joint enterprise will perform the service for members of the co-operative at the next level and will redistribute any surplus that accrues to these members.

The objective of co-operative enterprise is not to earn a maximum capital dividend for its shareholders, but to perform a service to the membership group. A set of principles has been developed to make this practicable and to safeguard the specific nature of a co-operative association. There shall be democratic control, and each member be given one vote. Interest on capital shall be limited to a fixed rate, and all surplus shall be distributed in proportion to patronage. Part of the surplus will be retained as reserve funds, so that the co-operative can expand its operations. Whether current market prices are charged in the transaction between the members and their co-operative and the surplus distributed later, or a cost price charged in the first place, is, in principle, irrelevant. Members individually withdraw from the market, in fact, when they decide to supply themselves co-operatively. There is a market only in the relations between the co-operative and the outside economy, but at more favorable conditions for participants in the co-operative.

Participating members decide voluntarily whether they avail themselves of the services of their co-operative or not. A co-operative is thus different from a medieval craft guild, where membership was compulsory and the object was not so much to

establish a joint enterprise, as to regulate the members' market. Likewise, a co-operative is entirely different from a trust, whose object is to dominate and manipulate a market. The object of a co-operative, in contrast, is to increase the efficiency of certain functions of its members, like purchasing, marketing, and obtaining credit or services, by performing these jointly.

The principle and the inherent advantages of large-scale enterprise have, in fact, long been accepted by small businessmen in Germany. They have made use of them through their own co-operative associations. "We cannot do away with big business and we need it," co-operators say, "so we build it it up on our own where it suits us." Large-scale organization based on the ideas of self-help, self-administration, and self-responsibility can compensate small business for its structural disadvantages in market relations, by developing countervailing power.

The practice of co-operative self-help in Germany began in a period of distress in the 1840's. The position of small independent craftsmen had become very difficult as a result of increasing competition from emerging industrial enterprise. Some demanded a return to medieval guild regulations by government action. Others advocated a system of relief. The pioneer of co-operative self-help among artisans and other independent people, Hermann Schulze-Delitzsch (1808-83), a district judge in the Prussian province of Saxony and Liberal member of the Prussian Diet, had come to the conclusion that both direct government action and relief work were not in the best interest of these people. He had confidence in their ability to improve their competitive position themselves and began to organize a number of local co-operatives among artisan groups in a few small towns: cabinet-makers' and shoemakers' co-operatives for pooling orders in the purchase of raw materials; credit co-operatives for the pooling of savings, and for supplementing credit needs by a mutual guarantee for bank credits; and marketing co-operatives for the sale of craftsmen's products. At about the same time, another co-operative pioneer, Friedrich Wilhelm Raiffeisen, developed co-operation among rural people in a very similar way. And this was only a few years after a group of weavers in Lancashire, the Rochdale Pioneers, had established their co-operative store in 1844 under the previously-mentioned co-operative principles. The important difference was that industrialization in England had progressed further and the Rochdale weavers had become employees. Under the strain of hardship, they set up their co-operative to improve their position as consumers, while the craftsmen in Germany who organized themselves in co-operatives were still independent producers. The consumers' co-operative movement has since spread from England all over the world, while producers' co-operation had its origin in Germany.

An ultimate objective, both in the attempts of the Rochdale Pioneers and of Schulze-Delitzsch, had been to establish co-operative workshops in industry which would be owned and controlled by the workers on co-operative principles. A number

of such productive societies have come into operation, but they have frequently failed.[1] Co-operation has since had its strongest development in those forms where members remain independent and the co-operative assists them in certain functions.

Small business in Germany has thus developed co-operative forms of enterprise in various sectors of its activity to utilize the advantages of large-scale organization. Numerous local co-operatives deal with the provision of raw materials, of credit, or of common services. Some have grown to regional size, and in order to increase their efficiency, all local co-operatives have, in a reapplication of the rationale of their own origin, joined in regional and central federations. These central agencies have been set up along the separate branches of co-operative activity and assist their member co-operatives by such services as wholesaling, importing, auditing, promotion, and consultant services. The central conference body of all business groups' co-operatives (for information services and representation in legislative matters) is the *Deutsche Genossenschaftsverband (Schulze-Delitzsch),* Bonn. Co-operative activity is usually carried out under the legal form of a co-operative association, as defined in the Co-operative Law, which was formulated at first in 1867 as a direct result of the work of Schulze-Delitzsch. But it is in no way confined to this legal form and has, in many cases, adapted other corporate forms for its use.

The most important group of small businessmen's co-operatives are retailers' and artisans' co-operatives for the purchase of goods and raw materials. They assume all functions of a wholesaler, such as storage, transport, risk-taking, and credit, and in addition, assist their members in advertising, market analysis, bookkeeping, and as technical consultants. They have their own co-operative brands, and in some instances, they have proceeded even to production. Table four shows the number

TABLE IV

PURCHASING CO-OPERATIVES OF BUSINESS GROUPS, 1957

Group	Number of Co-operatives	Annual Sales (million DM)
Retailers in Food and Tobacco	396	2,409
Artisans in Food	414	903
Nonfood Retailers	85	1,367
Nonfood Artisans	247	230
Other Business Groups	96	750
Total	1,238	5,658

SOURCE: JAHRBUCH DES DEUTSCHEN GENOSSENSCHAFTSVERBANDES 69-74 (1957).

and sales volume of such co-operatives. Of these 1,238 associations, two-thirds are in food distribution—mainly grocers' purchasing co-operatives like those in the

[1] New proposals to render the administration in this type of enterprise more practicable have been worked out by the Institute of Self-Help, Cologne, with reference also to countries that are now in the process of industrialization.

United States[2] and independent bakers' and butchers' purchasing co-operatives. These are owned and controlled by the shopkeepers and, therefore, differ from voluntary chains which are organized by private wholesalers. Co-operation among retailers and artisans in other sectors has shown some spectacular developments, but has not spread to the same extent. Other groups with their own purchasing co-operatives include restaurants, hotels, dentists, and private wholesalers.

The value of purchasing co-operatives to their members cannot be represented adequately by their sales volume, because the very existence of such enterprise also has an effect upon the prices and practices of manufacturers and private wholesalers. However, if we compare their scale with that of big business, we find that the aggregate sales of small business purchasing co-operatives in 1957 (DM 5,658,000,-000) correspond almost exactly to the aggregate sales of the largest private enterprise in the country, Krupp, and the largest public enterprise, Volkswagen, in the same year (together DM, 5,690,000,000). In this figure are not included the trading federations and the banks for co-operatives with their central credit bank, the *Deutsche Genossenchaftskasse,* Frankfurt.

The business group with the largest volume of co-operative purchases are grocers. Their 343 co-operative associations are grouped into two separate federations, Edeka with headquarters in Hamburg, and Rewe with headquarters in Cologne, whose services are so comprehensive that these grocers can compete successfully with chain stores. They do about one-third of all food retail business in the country. In spite of attempts to co-ordinate some of their retail marketing, the retailers have not given up any of their entrepreneurial functions. They only delegate them where they choose.

TABLE V

GROCERS' PURCHASING CO-OPERATIVES (EDEKA AND REWE ORGANIZATIONS), 1950-57

Year	Number of Co-operatives	Number of Members	Sales of Local Co-operatives (million DM)	Sales of Central Agencies (million DM)
1950	313	37,560	826	455
1955	328	47,600	1,749	1,113
1956	327	48,390	2,004	1,335
1957	343	50,400	2,216	1,489

SOURCE: JAHRBUCH DES DEUTSCHEN GENOSSENSCHAFTSVERBANDES 120-21 (1950); *id.* at 74 (1957).

Table five shows the development of these co-operatives since 1950. Their average membership today is about 150 grocers. They originated not in the days of Schulze-Delitzsch, when the position of independent retailers was yet undisputed, but after the emergence of large-scale retailing and consumer's co-operation in the 1880's. There were at first some qualms about endangering the position of private whole-

[2] Sometimes called co-operative chain stores. The term is subject to misunderstanding, however, as it can apply either to a consumers' co-operative chain store, or to a group of independent stores associated with a purchasing co-operative, or to a retail outlet of a farmers' marketing co-operative.

salers, but after several boycotts by manufacturers, the principle of group-purchasing was firmly established among retailers. Other groups of shopkeepers followed later and successfully organized trading co-operatives for textiles, footwear, hardware, stationery, and drugs.

Among artisans, where co-operation had begun at its very earliest stage, the expansion of purchasing associations has been more limited. This is largely due to the fact that in handicraft, the purchase of materials is a less important factor than

TABLE VI

ARTISANS' PURCHASING CO-OPERATIVES, 1957

Artisans' Group	Number of Co-operatives	Number of Members	Annual Sales (million DM)
Bakers	243	32,100	635.0
Butchers	171	22,000	268.0
Building trades	29	1,500	55.6
Tailors & Dressmakers	18	1,700	3.7
Hairdressers	15	2,100	10.0
Woodworking trades	34	2,000	15.5
Painters	37	6,500	35.6
Metalworking trades	25	3,700	64.7
Upholsterers	18	1,900	18.0
Shoemakers	60	6,200	15.5
Other groups	11	1,000	14.2
Total	661	80,700	1135.8

SOURCE: JAHRBUCH DES DEUTSCHEN GENOSSENSCHAFTSVERBANDES 69, 70, 128 (1957).

in retailing, and can, therefore, not yield such substantial savings. The great exception is baking. There are now 243 local bakers' purchasing co-operatives whose total sales volume exceeds that of all other artisans' co-operatives. (See table six.) Their membership figure represents more than half of the 55,500 bakers and confectioners in West Germany. In a bakery, flour is a crucial cost factor. Other requirements are also supplied by the co-operatives. In looking at the sales figures, one also has to take into account the sales volume of the specialized central wholesale agencies in the different branches—in the case of bakers, with sales of DM 203,000,000 in 1957—which is not shown. At present, new plans are under discussion that bakers give up making all varieties of bread which they sell, but instead hand over part of their production to local co-operative bakeries which will supplement their individual baking.

The situation is similar with butchers, where also about half have joined co-operatives. They buy their meat, however, mostly through municipal slaughter-houses; co-operatives handle only their other requirements and do the marketing of butchers' by-products. Upholsterers and home decorators have developed an interesting pattern of co-operative showrooms, with a greater variety of materials than they could have in stock individually. Customers can make their selection there, so that artisans are in a position to compete with department stores, without a high

investment in stocked materials. However, in many of the artisans' groups, shown in table six, co-operative members are only a minority of all artisans in the trade. This is partly explained by the fact that co-operatives have not been set up in all localities. In a few branches of handicraft, there is practically no co-operative purchasing, especially in those that have developed only recently, so that the figure of 80,700 members of co-operatives in all trade groups represents 10.6 per cent of the 752,000 artisan firms in existence. It is, in fact, more difficult for artisans than for retailers to run a co-operative business. They are trained to be craftsmen more than businessmen, and are unaccustomed to the task of supervising the operations of a purchasing association. Medium-sized artisan firms have more frequently made use of co-operatives than the very small ones, partly because the contribution of required share capital can act as a barrier. It is still an open question whether members who place larger orders shall be given preferential treatment in prices. This may be a necessary concession to keep them in the group plan, but it has always been controversial, because the members are, after all, competitors in their own market.

Some artisans' co-operatives have been set up to perform a marketing service for their members, mainly for the sale of highly specialized products like jewelry, musical instruments, and sets of surgical instruments, which are made by a number of artisans in a division of labor. Others seek to obtain government and export orders as bulk contracts for distribution among their members.

All these types of co-operative enterprise have helped handicraft to adjust itself to the conditions of a competitive economy. This had been the most important aim of Schulze-Delitzsch. He had rejected not only government regulations to assist small producers, but also government aid and government supervision of co-operatives. The co-operatives have since adhered to this principle, even under a democratic government. Some branches of handicraft had to give way to factory production as a result of technological development. These could, of course, not be saved by co-operative efforts, but to others, this has been a decisive factor. The persistence of so many small bakeries, for example, which sell directly to the consumer, can largely be attributed to successful co-operation.

Small manufacturers have been far more hesitant to solve some of their problems co-operatively. Their weakness in the buying market is less apparent than with small retailers and artisans. What they are lacking, for example, is access to facilities for research and new technological development. To solve problems which cannot be tackled by small and medium-sized firms individually, they can establish a joint research institute. This has been done in Norway recently. To accomplish this, business leaders must be willing to co-operate and even to reveal some of their own technical progress to the others. Mutual distrust has often been stronger. Manufacturers have not yet produced much evidence of co-operation, but have worked more through manufacturers' associations, whose main function is to co-ordinate complaints and to influence government regulations. It may be that they have come

to associate co-operatives so much with other groups in the economy, that they cannot think of themselves as co-operators. But it should be noted that there could be much scope for joint activity: small firms could establish co-operative export agencies, consultant services to advise on new techniques and plant layout, and electronic computing centers for the processing of data. Comparative cost analysis, standardization of goods, and a certain co-ordination of production could also be accomplished by such groups of firms. It may well be that we shall experience co-operative developments in these fields as the concentration of large-scale enterprise continues.

In transport, co-operatives have given very effective assistance to independent truck operators and shipowners. There are eighty co-operative associations in road and inland waterways transport, which secure the advantages of large firms for their members. They obtain freight orders, store goods in freight terminals, purchase requirements, finance members' operations, give credit for new equipment, and provide a repair service. They also negotiate with public authorities on behalf of their members. By this combination of services through their co-operatives, some 20,000 small transport firms have strengthened their competitive position and retained their independence.

In the vital field of credit, it has been possible in many cases, to overcome the limitations of small business by the functioning of co-operative credit banks. They serve artisans as well as retailers and small manufacturers, and provide an important link in the co-operative structure. They first had been established under the guidance of Schulze-Delitzsch, with two objectives in view. They function as credit unions by pooling members' savings and using them for credits to members when the need arises. Secondly, they supplement the credit volume which is thus available by bank loans from outside sources, for which the whole association gives a collective guarantee. The law provided unlimited liability of members at first and was later amended to permit limited liability. In this way, small firms were given access to credit sources which were, because of securities required by banks, not otherwise open to them. As these people's banks grew, they were able to provide more and more of the loans out of their own funds and those of co-operative central banks. In contrast to private banks, they give most of their credits to small debtors, but they have come to ask for much the same securities as other banks. In the years of extreme capital shortage following the war, artisans especially were in need of personal loans which could only be given on the basis of guarantee. Therefore, regional handicraft societies established regional guarantee associations which would help artisans get credit from people's banks or other banking institutions. They followed the example given by mutual guarantee associations in Switzerland, which have, however, been formed by small businessmen themselves over a period of decades and have received some government assistance.

People's banks in Germany have again accumulated funds and strengthened their position. Table seven shows their development since 1950. There has been a considerable increase of deposits and loans outstanding. The people's banks had, like

TABLE VII
People's Banks, 1950-57

Year	Number of Local Banks	Number of Members (thousands)	Deposits (million DM)	Loans to Members (million DM)	Balance (million DM)	Per Bank
1950	680	553	869	947	1,255	1,845
1955	688	631	2,538	2,413	3,402	4,945
1956	690	659	2,907	2,677	3,870	5,608
1957	692	687	3,502	2,909	4,563	6,542

Source: Jahrbuch des Deutschen Genossenschaftsverbandes 36-42 (1957), and previous yearbooks.

many other co-operatives, survived dictatorship and war and developed new growth in recent years. A large share of the deposits is today contributed not by small independent people, but by civil servants and employees, while most of the loans go to artisans, retailers, and, to a smaller extent, manufacturers. The local people's banks are federated into regional banks, which, in turn, obtain further credits through the central co-operative bank. For auditing and advisory services, they have, together with the trading co-operatives, joined regional co-operative unions and the central co-operative federation. In addition, there are two national banks to help them with special credits, a central co-operative mortgage bank, and a co-operative savings bank for building purposes. A postwar development has been the establishment of forty-seven co-operative installment credit banks whose function is to take the burden of installment credits which member retailers and artisans extend to their customers. Thus, they enable them to compete with the favorable terms which large firms offer in their sales efforts.

While the whole comprehensive structure of co-operative enterprise described so far works to improve the bargaining position and efficiency of existing small firms, there is another type of association whose object is to start its members in business after due preparation. The young grocers' saving association, called Spara, collaborates with the Edeka purchasing co-operatives. The members are employees who pledge to save regularly and who take special courses to prepare themselves to become independent grocers. After three years of saving, they can obtain a personal credit from the Edeka Bank. This will be up to seven times the amount the saver has contributed, and at a rate of interest equal to that which was paid to him. The association will help in finding a suitable shop and in negotiating a lease, and the Edeka bookkeeping service will help with the records. The loan is then to be repaid in three years. Spara associations have been established by Dr. Paul König of the Edeka since 1930, and since 1950 alone, some 300 young grocers have been launched as independent retailers. They have come to know the ideas and the scope of self-help at an early stage and provide a new influx for purchasing co-operatives.

A similar method to promote independence with a training for self-responsibility has been adopted by bakers, butchers, and other artisans' associations. These work

in close collaboration with people's banks, and even though these savings plans have only been in operation for a few years, there are already some 7,000 young artisans' savings accounts under this program. As the amount of capital required for the establishment of a new business has become a crucial barrier, it is to be expected that such co-operative plans to facilitate ease of entry will gain in importance. Some of these various types of co-operatives which have been set up in Germany, have also been developed in other countries at about the same time or have later been adopted there. Although there were contacts between co-operative pioneers, as between Hermann Schulze-Delitzsch and Luigi Luzzatti in Italy, the course of development has sometimes been different. Especially the role of the state has often varied.

Purchasing co-operatives of food retailers exist in many European countries. The principle of local associations with a central federation has, in the same way as in Germany, been adopted in Austria (Adeg organization), the Netherlands (Sperwer and Enkabe organizations), and Belgium (Cenko organization). In France, there are a number of local associations, especially in the East and North, but no regional or national trading federation. In Switzerland, Sweden, and Norway there are no local associations, but a number of regional purchasing co-operatives with a loose national federation. Denmark has regionals without a federation. In Finland, the retailers are direct members of a centralized national organization, Kesko, which is, in spite of a strong consumers' co-operative movement, the largest wholesaler in the country.[3] There are also purchasing co-operatives for other sectors of retailing in some countries. Sometimes these purchasing associations have, as in Germany, adopted not the legal form of co-operative, but some form of joint stock corporation where retailers are the shareholders.

Co-operative people's banks that have been established in other countries are often built on a much stronger element of central control. The pattern of numerous local banks for small enterprise with their federal organizations, which is typical for the German people's banks, is also found in Austria, Italy, and in the French-speaking part of Canada. In France, Belgium, and the Netherlands, there are centralized people's banks which are semipublic, but France has also a substructure of local mutual guarantee associations and less numerous people's banks. A recent development of co-operative credit has taken place in Turkey, where a centralized people's bank serves the whole country in collaboration with local guarantee associations.

In some countries, the government has been called upon for providing only the legal status which co-operatives require for their functioning. In others, it has been active in promoting the establishment of co-operatives. In a number of countries, the government has, when it was decided to give some form of public assistance to small businessmen, directed funds through co-operative enterprise to increase the capacity for self-help and to develop self-responsibility among those concerned. This

[3] See PAUL KÖNIG, SELBSTHILFE IM WETTBEWERB 12-16 (1956).

course of action may well be adopted as a policy in those countries which are now striving for economic development.

In any case, the voluntary effort of small businessmen is necessary as a basis. This has been lacking in some Mediterranean countries, with their traditional individualism, and in England, where it seems that small independent producers and retailers have just gone out of business when conditions have turned against them. Perhaps they did not think of forming co-operatives of their own because they felt strongly against the competition of consumers' co-operation, which, to them, had a socialist flavor. In other countries, where government aid has been an important factor in co-operative development, there has often been a lack of lasting self-help efforts. This can be avoided when public aid is only used as an initial assistance to stimulate voluntary co-operative action. In countries where self-help has shown its strongest development, co-operators have rejected state intervention. Co-operation will flourish best in freedom of enterprise.

Co-operatives have protected the independence of small businessmen against intrusion by stronger competitors *by increasing the competitive strength of independent enterprise*. They have made them a more vigorous partner in the competitive economy and have, above all, increased confidence in their ability to sustain their independence.

SMALL BUSINESS AND ITS PROBLEMS IN THE UNITED KINGDOM

D. G. RICE*

I

DEFINITION, ORGANIZATION, AND HUMAN ASPECTS OF SMALL BUSINESS

Any examination of the problems of the small business in the United Kingdom necessarily presupposes an acceptable definition of what constitutes "small business." "Small," like "big," is a relative term. What is small in one context is large in another, and what is insignificant to one person appears immense to someone else. Indeed, any attempt at prescribing the extent to which a business can grow before it ceases to be small is liable, in the very nature of things, to meet with criticism based on purely subjective considerations. Nevertheless, however difficult the task may be, a definition of the term "small business" is a prerequisite of any discussion of its problems. But before we attempt a definition, it is necessary first to review briefly the different legal structures under which the commercial life of Great Britain is conducted.

The simplest and least sophisticated form of business is that carried on by an individual trader acting on his own account or in partnership with one or more others. Such a business structure does not, of course, confer limited liability, and, being unincorporated, the intrinsic difficulties of obtaining capital are further aggravated by the severe restrictions imposed on the mortgaging of chattels by the Bills of Sale Act, 1878-82,[1] and the Bankruptcy Act, 1914.[2] Moreover, it must also be remembered that a partnership,[3] not having perpetual succession independent of its members, is liable to dissolution on the voluntary determination, death, or bankruptcy of any member (and by way of corollary, the interest of each member is necessarily nontransferable); that the need for each member to exercise managerial functions inevitably precludes the membership of the firm from expanding too far;[4] and that the personal liability[5] attaching to each member for the business debts of the undertaking acts as a brake on the admission of further partners in the absence of

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[1] 41 & 42 VICT. c. 31, and 45 & 46 VICT. c. 43.

[2] 4 & 5 GEO. 5, c. 59.

[3] Whose legal structure is now governed by the Partnership Act, 1890, 53 & 54 VICT. c. 39.

[4] In any organization, there is a natural limit to executives of roughly equal standing. Moreover, the law acknowledges the situation by restricting, at the moment, the number of partners to 20.

[5] Since the Limited Partnership Act, 1907, 7 EDW. 7, c. 24, it has been possible to have partnerships with limited liability where a partner does not take any active part in the business. They have not, however, proved very popular in practice. The sleeping partner will automatically become liable if he even slightly intermeddles wtih the firm's affairs, and when things are going badly, there is a great temptation to try to save the sinking ship.

complete confidence in their ability and integrity. Accordingly, the unincorporated concern is not a very satisfactory medium for the development of industrial empires. It is, indeed, a structure suitable only for professional firms and commercial businesses conducted on a very modest scale.

By far the most important organizational form for commercial and industrial undertakings today is the limited liability company. It can assume either a private or a public form, the former having received official recognition in the Companies (Consolidation) Act, 1908.[6] The private company is generally, though not necessarily, smaller than the public company and is frequently little more than the incorporated embodiment of the old-fashioned partnership. But each "partner" (now called "director") can feel sure that his private fortune cannot be called upon to defray the debts of the business, and he can at any time retire or die without disruption to the business as such. He cannot, of course, withdraw his money,[7] as he could in the case of a partnership, but he can always transfer his interest elsewhere (though it does not necessarily follow that the value of his shares will correspond to that of the capital he contributed in the first place).

Because of the family association of private companies, the law has from the start imposed limitations on the flexibility of their constitution. It has restricted the membership to fifty (excluding present and past employees), curtailed the right to transfer shares, and prohibited any invitation to the public to contribute capital.[8] The essential intimacy of private companies and their affinity to partnerships made it only reasonable to preserve their character by restricting their connection with the investing public at large. And to a large degree, the law only did what the members wanted anyway—*i.e.,* it debarred "outsiders" from membership.

By way of corollary, the law originally exempted all private companies from compliance with certain formalities designed to protect the investing public, and in particular from the obligation to file accounts. Unfortunately, certain large public companies began to cloak their activities behind a front of private companies, thereby forcing the law to distinguish between those companies that were really genuine family concerns and those that were not, now known, respectively, as exempt and non-exempt companies. The latter have lost most of the privileges belonging to the pre-1948 private companies, and in particular are deprived of their exemption from the obligation to file accounts. The exact definition of what constitutes an exempt private company is contained in section 129 and schedule seven of the Companies Act, 1948.

Although in the case of the family private company, management and ownership are still strongly connected, the position is generally otherwise with the older legal

[6] 8 EDW. 7, c. 69. For a full and erudite discussion of the English private company, see Professor L. C. B. Gower's contribution to the symposium on *The Close Corporation*, 18 LAW & CONTEMP. PROB. 534 (1953).

[7] Subject to a return of capital under § 66 of the Companies Act, 1948, 11 & 12 GEO. 6, c. 38, or a winding-up.

[8] See Companies Act, 1948, 11 & 12 GEO. 6, § 28 and pt. II, art. 2, of table A.

creation—the public limited company. Here the investing public are invited to subscribe funds, in return for which they receive dividends but assume only a passive role in relation to the affairs of the company. In consequence, the law requires full disclosure to be made of the company's accounts to the world at large, and no restriction is placed on the transferability of its shares. Such companies can be classified into those that enjoy a public quotation and those that do not. By a public quotation, we mean the appraisal of the company's stocks and shares on the London or any provincial stock exchange.

Generally speaking, all the large companies either have their share capital publicly quoted or are subsidiaries of companies in this position. Numerically, however, private and nonquoted companies preponderate by far. According to the pamphlet entitled *Company Income and Finance 1949-53* compiled by The National Institute of Economic and Social Research, London, in 1953, there were 270,269 companies with share capital, of which only 11,444 were public companies, and of these a mere 3,000 or so actually enjoyed a quotation.[9]

However, this vast numerical difference should not lead the reader to underestimate the importance of the quoted sector of industry. An attempt has been made by the National Institute to assess the relative importance of quoted companies as against the rest. With respect to the paid-up capital, those companies whose securities are quoted account for £2,740 million—*i.e.*, forty-three per cent of the total of £6,412 million for all companies and sixty-seven per cent of the total of £4,062 million for all public companies. Viewed from the standpoint of profits, the quoted sector earned during the period 1949-53 fifty-six per cent of the total corporate profits (the figure for manufacturing industry as distinct from building and distribution being seventy-one per cent), and the percentage rose during the quinquennium from fifty-one to sixty per cent. As for personnel, the National Institute estimates that something like fifty-eight per cent of the total manpower absorbed in manufacturing[10] industry is employed by quoted companies; or, if we take into account the greater productivity of the large concern per person employed and measure in terms of "added value" or "net output," we find that the share attributable to quoted companies would amount in all probability to about fifty to fifty-two per cent of manufacturing industry. Finally, if we take as our criterion the number of persons employed in manufacturing establishments, where the average number is only sixty, the corresponding figure for establishments operated by companies whose securities are quoted amounts to no less than 340. Clearly, then, it is the quoted company that is the real giant of British economic life.

Having examined briefly the different legal structures under which commercial enterprise is conducted in the United Kingdom, we have yet to determine what

[9] Companies are only included in the survey if their main activity is directed to manufacturing, building, or distribution in the United Kingdom. Thus, companies engaged in banking, insurance, finance, property, shipping, and agriculture have been excluded, and the same is true of companies operating principally overseas (*e.g.*, oil corporations). Furthermore, no cognizance is taken of nationalized industries.

[10] No figures are available for distributing organizations.

constitutes "small business." Quite clearly, both the undertaking of the sole trader and the partnership must come within this classification. The very nature of these forms of business structure prevents any substantial growth. Moreover, it is reasonable to regard private companies in the same light. Admittedly, it is possible to find undertakings of this kind commanding very considerable financial resources and employing many hundreds of workers. But that is exceptional. Moreover, as we have demonstrated statistically, even where public companies are concerned, it is those enjoying a stock exchange quotation that can generally be said to qualify as the giants of the industrial and commercial life of the United Kingdom. Accordingly, in defining what constitutes small business, we will regard as falling within that classification all enterprises that do not enjoy a quotation of their shares on the London or any provincial stock exchange.

Now that we have defined what constitutes small business, we can proceed to consideration of the problems that are peculiar to it. Our discussion will have to embrace all the different legal structures to which we made reference; but it will simplify our examination if we direct our remarks to the private limited company (which is, in fact, the most common form under which small business is conducted), making qualifications where the other types of structure so require.

The small business tends to be family in character, and from this, there emerge two human problems that perennially confront it. The first involves the frailties of man's nature. Jealousy, though endemic in all human relationships, seems to be particularly pronounced where families are concerned, and hence the family business is wide open to the undermining influence of family feuds. Time and again, where total strangers would work in complete harmony in their business affairs, families find themselves involved in petty squabbles within themselves. One of the inherent weaknesses of a family concern is that family considerations tend to get projected into a business relationship. Thus, the commercial and intellectual gifts of one brother or cousin tend to be equated within the family to those of another brother or cousin. In the family scale of values, one brother or cousin is equal to another brother or cousin, the realities of the situation being totally disregarded. Moreover, even where lip service is paid to the undoubted differing abilities of different members of the family, we still find deeply ingrained in the family subconscious the unyielding conception of family equality. Now, in the highly competitive world of industry and commerce, there is no scope for any internal disharmony. A ship divided must founder. It would, indeed, be interesting to know (though, of course, impossible to ascertain) how many family businesses have over the years failed through sheer internal discord.

The second difficulty of the small business is that its success or failure tends to depend to an inordinate extent on the personality of the managing director.[11] In fact, the smaller the business, the greater the dependence. For quite clearly, the scope for delegation of responsibility and employment of high-grade personnel at com-

[11] Equivalent to the American president.

mensurate salaries is correspondingly reduced. Where a business is essentially family in character, the managing director will usually have to be drawn from the family. The business is rarely of such a size as to allow management to be divorced from ownership. Rarely is it in a position to employ on a strict managerial basis an executive of sufficient calibre that the whole control of the enterprise can be safely entrusted to him. Although the original managing director of a small business which has been successful may have been a man of great drive and ability, there is no guarantee that his son or nephew will possess similar qualities. In contrast, in the case of a large concern, the undertaking is run by a managerial class; and the larger the company, the less dependent it is on the personality of any one man. In fact, the departure of the managing directors of most of the leading industrial concerns would, it is submitted, have little impact on their immediate profitability.

II

FINANCE OF SMALL BUSINESS

A. Raising of Capital

Leaving the human problems inherent in the small business, we turn to another difficulty, no less great—that of raising capital. The two principal sources of permanent capital are to be found in the investing public and in the large financial institutions with pension and other funds ready to invest. But in our discussion above of the legal status of the private limited company, we pointed out that this form of organization is precluded from inviting the public to subscribe for any of its shares or debentures.[12] The consequence of this is that one of the two main sources of permanent capital is automatically cut off from the private company. The small business simply cannot resort to the investing public.[13]

However, there is no legal embargo on an application to individual institutional investors. But here, again, the chances of success are slight, for the legal status of the private company militates against any support from this quarter. As has already been explained, the private company is compelled to restrict the right to transfer its shares, and must limit the number of its shareholders (excluding present and certain past employees) to fifty. The result is that its shares are sadly lacking in marketability and hence are not particularly attractive to institutional investors, since they cannot easily realize their investment. Of course, this does not imply that the institutions never hold unquoted securities. They are prepared to include in their portfolios some unquoted securities (particularly preference shares redeemable over a fifteen to twenty-year period), but the proportion is severely limited,[14] and their acceptance of

[12] However, it must be remembered that even if it were allowed legally to make a public issue (as are the sole trading concern and the partnership), it is doubtful whether *economically* this would be a practical proposition in the vast majority of instances. It would certainly not be so in the case of the sole trading concern or the partnership.

[13] Reference is made to resort by means of an open invitation to the public at large. The company can, of course, approach certain members of the investing public on a *private* basis.

[14] It should be pointed out in fairness, however, that with the continued growth in pension funds and the need to find higher yields than those obtainable from gilt-edged securities on a proportion of their investments, more funds are being made available for investment in unquoted securities.

them is often subject to the condition that the company will, at its own expense, apply to the stock exchange within a fixed period of two or three years for a quotation. Moreover, when they are prepared to hold shares whose marketability is severely restricted, the return they require by way of compensation must be correspondingly higher. The result clearly is that the cost of obtaining institutional support, where it is forthcoming, is greater for the small business than the large. And, in addition, since most institutional investors are nonexempt companies, if by the financial transaction they control one-fifth or more of the total voting power of the private company,[15] the latter company loses its exempt status (assuming, as is usually the case, it, in fact, previously enjoyed this advantage) and with it, the benefit of not having to file a balance sheet at the Registry of Companies.

Although a private company is prevented by law from inviting the public to subscribe for its shares, it is not precluded from having its securities privately placed by stockbrokers who specialize in this class of business. However, it is difficult to arrange this unless a public quotation is probable in the near future. Even here, the clients require an above-average yield, so that the cost to the small business of raising capital (in so far as it is available to it) is appreciably higher than it is to its larger rival.

Quite apart from their lack of marketability, shares in private companies are singularly unattractive to investors on another score. The private character of this type of company tends to undermine the position of those who have subscribed capital to it. When once the investor has parted with his money, he renounces all entitlement to it and takes in exchange a bundle of rights. Although these rights—including, as they do, rights of voting, rights to dividends, and rights on a winding-up—are extensive, they are not identical with ownership of the capital sum subscribed. Hence, the investor's financial stake in the company must be measured not by the monetary value of the capital he has put up, but by the worth of the rights which he enjoys in the company. If he is a minority shareholder, his legal position may be far from enviable. In spite of the recent extension of minority protection by the House of Lords in *Scottish Cooperative Wholesale Society, Ltd. v. Meyer*,[16] it is a commonplace of English company law to say that, where an unscrupulous majority is intent on oppressing the minority, it is unlikely to be balked in the attempt.

However, as far as public companies are concerned whose shares are quoted on a stock exchange, the chances of flagrant oppression are considerably reduced. The mere fact that such companies are large and function very much in a public climate tends to cause their boards of directors to be men of high principles. Their office is semipublic, and, generally speaking, they regard their duties as those of trustees. And, again, an oppressed minority can find very considerable protection in the financial press. Any flagrant instance of oppression will certainly be revealed there; and, quite apart from the high moral principles usually associated with directors of

[15] Companies Act, 1948, 11 & 12 GEO. 6, sched. VII, para. 7.

[16] [1958] 3 W.L.R. 404 (the case dealt with interpretation of § 210 of the Companies Act, 1948).

quoted public companies, there are few businessmen who would wish to see their activities publicly exposed by various financial correspondents only too eager to bring to the light of day any shady business which they may think they have discovered. Moreover, from a practical standpoint, the mere fact that a public quoted company will almost certainly have hundreds, if not thousands, of shareholders, helps to prevent the possibility of minority oppression. The mere deployment of interests militates against a ganging-up of an unscrupulous majority.

In the case of a private company, however, none of these safeguards applies. There is not the same guarantee of high-principledness in the directors; there can be no exposition of oppression in the financial press; and, since the number of shareholders is strictly limited, the chances of one or two members combining to oppress the others are immensely enhanced. It is not surprising, then, to discover that on this score as well as lack of marketability, the private investor is reluctant to contribute funds to an unquoted company;[17] and, even if he does so, the compensatory reward must be such as to render the cost of raising capital for a small company considerably higher than it is for its large quoted counterpart.

Since it is difficult for a private company to raise permanent funds from institutional or private investors, certain semiofficial bodies have been set up to assist small and medium-sized firms.[18] The most important, as far as the small business is concerned, is the Industrial and Commercial Finance Corporation (ICFC) which was established in 1945 with the support of the Bank of England and the London and Scottish Clearing Banks. Its object is to provide small and medium-sized companies, unable to obtain permanent funds from other sources, with sums of between £5,000 and £200,000, either by way of a loan, secured or unsecured, or by the taking up of preference shares.[19] In addition, the ICFC may require as part of the arrangement that it shall have the option of subscribing for a small proportion of the equity capital on certain prescribed terms. Moreover, bonus debentures may be created from unappropriated revenue reserves and sold to the ICFC on the basis of their redemption over a twenty-year period.[20]

The object underlying the creation of the ICFC is, of course, to prevent new development being concentrated unduly within the ambit of strongly entrenched concerns. The value to the economy of the new small business is acknowledged in the setting up of the ICFC. Needless to say, before lending money, the Corpora-

[17] He will generally only do so where there is complete confidence and trust or where family considerations outweigh normal commercial prudence.

[18] It should also be noted for completeness that apart from any help from this quarter, permanent working capital can be obtained by private companies from certain indirect sources. If they happen to own freehold property, they can mortgage it, or alternatively they can sell it outright taking back a lease at a rack rent. Or negatively, they can sometimes save working capital by renting factory space on one of the government-sponsored trading estates. However, these factors do little to alleviate the fundamentally difficult position of the small business in raising permanent capital.

[19] It also provides the services of experienced and qualified advisors and technicians. It does not, however, interfere with the management of the company.

[20] The debentures may confer a first charge on the fixed assets of the company and a second floating charge. This will not prejudice the obtaining of bank credit, in that the bank may take a first floating charge and a second charge on the fixed assets.

tion carries out a full survey, and may require the right to appoint a director. At any event, it will normally call for monthly figures showing the financial and trading position of each client, which will, of course, be to the interest of both parties.[21]

Although the setting up of the ICFC is a very welcome step in the direction of providing finance for the small and medium-sized business,[22] fundamentally the raising of permanent funds still remains a problem of great difficulty. Indeed, the opportunity for expansion would largely be denied the small business were it not for the reasonable availability of temporary financial accommodation. There is nothing to stop the small business from resorting to the bank.[23] In fact, many big businesses owe their success, in very large measure, to the sustained support of their bank throughout their whole period of growth, from insignificance to a position of national or international standing. However, although the banks are willing to accommodate small businesses,[24] they will be particularly cautious in their dealings with them. For example, they may and usually do require personal guarantees from the directors—*i.e.,* the banks go behind the veil of incorporation. They require as proof of the directors' confidence in the project for which the loan is required an acceptance by the directors of personal liability for repayment. Thus, in order to obtain financial help, the owners of the small business have to surrender one of the most valuable advantages of incorporation—limited liability.[25] This is but an illustration of the age-old principle that there is one rule for the rich and another for the poor.

Apart from bank loans (and to a limited extent, where the standing of the company is good enough, bills of exchange), fundamentally the private company is dependent for its expansion on ploughed-back profits. Admittedly, it may often acquire equipment on hire-purchase, thereby obtaining immediate use of the equipment but paying for it out of earnings. However, the charges for this facility are generally penal. Accordingly, a private company must exercise great restraint in its dividend policy. For many years, the shareholders must be prepared to sacrifice the present for the future. This policy may often have to endure for the best part of a lifetime; yet, there is no other real way of accumulating the necessary reserves out of which sustained growth can emerge. The extent to which profits can be ploughed back into the business will depend on the extent to which the company is allowed to retain them. At once, we are brought face to face with the problem of taxation.

[21] The ICFC has now been supplemented by a number of other bodies such as Estate Duties Investment Trust Ltd., to which reference is made, note 44 *infra,* the Charterhouse Industrial Development Co. Ltd., Private Enterprises Investment Co. Ltd., and Glasgow Industrial Finance Co. Ltd.

[22] The Corporation's loans and investment holdings on March 31, 1958 exceeded £34 million and its customers amounted to more than 620.

[23] The sole trader and the partnership firm will find it more difficult to obtain bank accommodation than will an incorporated body, in that the latter can grant a floating charge over its assets by way of security.

[24] But not so (or only to a very limited extent) during a period of "credit squeeze," such as that through what the United Kingdom has just passed.

[25] The surrender is restricted, of course, to the amount of the loan.

B. Problems of Taxation

Fundamentally, the weight of taxation falls more heavily on those companies which do not have the benefit of a stock exchange quotation.[26] The rationale behind the disparity of treatment is the determination of the Inland Revenue to prevent wealthy men from carrying on trading activities under cloak of private limited companies, with the full benefit of the tax concessions granted to genuine bona fide trading corporations.[27] Accordingly, in assessing unquoted companies for taxation, the Inland Revenue goes behind the veil of incorporation and looks to the "control" of the company. In this short survey of the problems of the small business in the United Kingdom, it is inappropriate to attempt to encompass all the intricacies of tax law connected with the form of business structure we are considering. We will simply sketch some of the principal problems that confront it.

The first difficulty is that under sections 245-64 of the Income Tax Act, 1952,[28] a surtax direction order may, in certain circumstances, be made by the Special Commissioners against any company incorporated in the United Kingdom if it is controlled[29] by not more than five persons (of whom certain classes, such as relatives, are deemed to be one) and if it is not a subsidiary of a company which is itself immune from a direction, and if the public is not substantially interested in it (which means, in practice, that the public do not hold at least twenty-five per cent of the equity capital). The liability of such a company to a direction order will arise when, in the view of the Special Commissioners, a reasonable[30] distribution of profits has not been made by way of dividend. The effect of a direction is that, in so far as surtax computations are concerned, the *whole* profits will be apportioned among the shareholders, who will be assessed accordingly. Then, unless the latter elect to pay the tax, it will be recovered from the company itself.

Clearly, there are very few family concerns which will not be caught by these provisions (particularly as relations are deemed to be one legal person), and the only practical way for a company of reasonable size to escape the consequences is to obtain a quotation for twenty-five per cent of its equity capital. However, since the war, the above provisions and their forerunner, section 21 of the Finance Act, 1922,[31] have, until comparatively recently, had little effect on small businesses because of what is known as the "Chancellor's Umbrella." In 1947, when under a Socialist government the political climate was strongly against dividend distribution, the late Sir Stafford Cripps (then Chancellor of the Exchequer) gave an assurance in Parliament that in the case of bona fide trading concerns, where no tax-avoiding device was in evidence, no new direction order would be made, even if profits grew without any corresponding dividend increases. However, in 1957, the protection of the Chancellor's

[26] Which, for the most part, will be the private companies.
[27] They must not be allowed to use such a cloak for reducing or eliminating their liability to surtax.
[28] 15 & 16 GEO. 6 and 1 ELIZ. 2, c. 10.
[29] For a definition of the meaning of "control," see *id.* § 256.
[30] What is reasonable will depend, of course, upon the circumstances of each individual case.
[31] 12 & 13 GEO. 5, c. 17.

Umbrella was specifically withdrawn, thereby exposing small businesses to the hazard of the working of sections 245-64. It is too early to say what in practice has been the effect of the change, but, in theory at least, the small company is prevented from ploughing back profits *to excess*. As the small business is so dependent on accumulated reserves, the withdrawal of the Chancellor's Umbrella must tend to curb the growth of the private company.

Apart from income tax, all limited companies are liable to profits tax on annual earnings over and above £2,000.[32] Private companies, however, are apt to meet with much more severe treatment in this respect than do those of their competitors which enjoy a quotation for their share capital. Many private companies are "director-controlled"—that is, more than half the voting power is controlled by the directors. When this happens, certain items are disregarded as expenses in computing the company's earnings for profits tax purposes. Thus, loans to shareholders are treated as a distribution subject to profits tax; and debenture interest is not an allowable expense if it is in favor of a director other than a full-time service director.

Far more important is the inadmissibility as a trading expense of directors' remuneration beyond certain specified figures. Although the earnings of full-time service directors—directors who are employed full time in some managerial or advisory capacity and who do not own or control more than five per cent of the equity capital—will be disregarded in computing profits tax, the remuneration of other directors will invariably be taken into account, subject only to relaxation in the following two respects. First, a deduction will be admissible to the extent of £2,500 or fifteen per cent of the assessed profits (limited, however, to £15,000), whichever figure is the higher; and, secondly, where there are "qualifying" directors —directors who devote *substantially* the whole of their time to the service of the company in some managerial or other capacity—the company can, by way of an *alternative* to the relief just mentioned, claim the right to deduct from profits directors' remuneration in accordance with the following formula:[33]

£2,500 for one qualifying director;
£4,000 for two qualifying directors;
£5,500 for three qualifying directors; and
£7,000 for four or more qualifying directors.

Needless to say, in many cases, the salary scale admissible under the above formula for "qualifying" directors is quite unrealistic. Accordingly, the director-controlled private company[34] will find itself severely penalized in the computation of its profits

[32] The business of persons trading as individuals or partners will not be liable to this impost; nevertheless, the owners will be liable to surtax, which on incomes over £15,000 per annum can be at the rate of 92.5%.

[33] This formula is subject to safeguards to prevent the board from being artificially augmented by qualifying directors with purely nominal salaries in order to enable the "real" directors' remuneration to be kept within the allowable deduction.

[34] The penalty will also apply to a public company, provided its share capital is not quoted. Once a quotation is obtained, the handicap of being director-controlled is at once dispelled.

tax liability.[35] Admittedly, on annual profits between £2,000 and £12,000, an abatement relief is obtainable,[36] but this is unlikely to offset the penal effects of restricting the extent to which directors' remuneration is admissible as an expense for profits tax purposes.[37] Once again, we have a case where the private company is oppressed by taxation more seriously than is its quoted counterpart; and, as was indicated earlier, the more it is prevented from accumulating profits, the more the opportunities for expansion will be curtailed, since the private company depends so vitally upon ploughed-back profits for its development.

Again, a private company is apt to find itself prejudicially affected by the death of a substantial shareholder; the need to satisfy the crippling demands made in respect of death duties may well result in the break-up of the company or its absorption by a larger concern, its character and individuality thereby being lost forever. The position is at its worse where section 46 of the Finance Act, 1940,[38] applies. Under this section, where a person has contributed assets to the company (as, for example, will be the case with the founder), regardless of whether he owns any shares at his death or does not do so, his estate will be charged with that proportion of the company's assets which the value of all benefits received by him during the five years prior to his death bears to the total income of the company during that period; and the company will have to account for the tax. Thus, if a company, during the five years in question, should earn £50,000 and the deceased should have received £25,000 in remuneration and other benefits, then, regardless of the extent of his shareholding (which may in fact be nonexistent), he will be deemed to own half the company, and the company will be liable accordingly. Fortunately, however, it is not the practice of the Estate Duty Office to enforce this provision where the contribution to the company's assets has been made in the normal course of business and there has been no attempt to adopt any tax avoiding device. Instead, it will normally be satisfied with a valuation under section 55.

Under that section, where the deceased, within five years of his death, had con-

[35] The directors of a director-controlled company (if they own or can influence more than 5% of the equity capital) will also find themselves under a severe handicap from the point of view of pensions. They cannot take part in "top-hat schemes" (schemes designed for higher paid executives and requiring in each case specific approval by the Inland Revenue), where contributions are treated as an expense for the company and are not regarded as benefits in the hands of the persons for whom the pensions have been taken out. However, the worst effects of this have been mitigated by the Finance Act, 1956, 4 & 5 ELIZ. 2, c. 54, under which controlling directors, in common with other self-employed persons, can enter pension schemes which do not fall far short of the "top-hat schemes" in the benefits they confer.

It should also be noted that controlling-directors will probably find the Inland Revenue paying particular attention to any benefits in kind that they may have received.

[36] Arrived at (where there is no franked income) by taking one-fifth of the amount by which the profits fall short of £12,000.

[37] Moreover, the Inland Revenue has wide power to circumvent the effects of profits tax avoidance devices.

[38] 3 & 4 GEO. 6, c. 29.

trol[39] of the company, his shares will be valued on an assets basis—that is, they will be deemed to be fractions of the company's total net assets. Of course, it is exceptionally difficult to value a private company's assets;[40] and, even if this hurdle is successfully negotiated, to regard someone's shares as worth a proportionate part of the assets is usually quite unrealistic. The holder or his personal representatives normally could never hope to get this price on the open market.[41] Fortunately, under the provisions of the Finance Act, 1954,[42] certain reliefs are obtainable; but, nevertheless, death duties may be so great as to cause the company to be broken up or sold to a larger concern. So may end a life's work!

Moreover, even where section 55[43] is not applicable, the deceased having never had control of the company, the valuation of shares in private companies, which must be arrived at on the principle of an imagined sale between a willing buyer and a willing seller, may be quite unrealistic in view of the restrictions necessarily imposed on the transfer of such shares. In fact, the shares may sometimes be quite unsalable. Once again, death duties may have devastating effects on the whole character and personality of the company.[44]

A quoted company, however, is quite unaffected by the above considerations. Neither section 46 nor section 55 can apply, and the valuation given to the shares will be that ruling on the stock exchange at date of death. Under no circumstances will the Inland Revenue have recourse to the company's assets.

One final point should be made about taxation as far as it concerns the small business. Until the Finance Act, 1958,[45] the amount payable by way of profits tax on a company's earnings was thirty per cent, with relief at the rate of twenty-seven per cent on earnings not distributed. This represented a major concession to the private company as against its quoted counterpart, in that—since the former was so much more dependent for its development on the accumulation of past profits—the policy it generally adopted of declaring low dividends resulted in a considerably reduced liability to profits tax. However, since 1958, a flat rate of ten per cent has been imposed, regardless of whether or not profits have been distributed. This change must prejudice the position of the small business in its struggle to find capital for its development.

[39] Command of a bare 50% of the voting power will suffice. For a definition of "control," see the Act.

[40] These difficulties are discussed in *In re* Holt, [1953] 2 All E.R. 1499. See further Dean v. Prince, [1954] Ch. 409 (C.A.), and Trew, *Executors and the Private Company*, [1957] J. Bus. L. 26, 30-32.

[41] The holding of at least 75% of the voting equity is, commercially speaking, a minimum prerequisite for any direct equation between share values and the company's assets.

[42] 2 & 3 ELIZ. 2, c. 44.

[43] For completeness, it should be noted that neither § 55 nor § 46 apply while a company is not privately controlled within the test prescribed by § 21 of the Finance Act, 1922 (as slightly extended).

[44] However, an attempt has been made to mitigate the position by the setting up of Estate Duties Investment Trust Ltd. ("Edith"), financed by the ICFC and certain insurance companies and investment trusts. The purpose of "Edith" is to provide "a reliable and neutral means for acquiring and holding as an investment" shares in private companies, without interfering with their management.

[45] 6 & 7 ELIZ. 2, c. 56.

III

ECONOMIC DIFFICULTIES OF SMALL BUSINESS

A. Technological Advances in Distribution

So much for the problems of small businesses that stem fundamentally from their legal status! We must now turn to the economic difficulties that face them at the present time. It should first be mentioned that the small business tends generally to be found among manufacturers of consumer products and retailers, rather than among producers of capital goods.[46] Normally, the restricted funds available to the private company either preclude entry into the latter field or, at any rate, drastically curtail any significant development therein. Thus, it is unrealistic to imagine a small company embarking on steel production, motor car or aircraft manufacture, mining, chemical engineering, shipbuilding, or similar undertakings.

In the manufacture and retailing of consumer goods, however, the situation is totally different. In fact, the small shop is one of the traditional manifestations of the small business. It is here, perhaps most of all, that the small concern is facing the impact of new techniques. In recent years, the principles of mass-production have spilled over in full force to the distributing side of economic life in the United Kingdom. In an attempt to cut the costs of selling (particularly as far as labor is concerned), we have witnessed the rapid growth of the chain store and the development of the supermarket.[47] They are both based on the principle that the purchaser shall do the work of selection and the seller will merely lay out the goods. Traditional selling methods and their high cost are thereby eliminated. Hence, in a chain store, low-grade assistants can be employed whose principal function is to collect the money for purchases and stop petty pilfering; or in the case of a supermarket, there are no sales assistants at all in the traditional sense. The goods sell themselves, and the management merely provides the requisite organization. In other words, techniques analogous to those commonly associated with production methods are being applied to distribution; and, needless to say, the source of this movement is to be found in the United States of America.

The result of this development has been to prejudice the position of the small retailer in the United Kingdom. Not merely are the chain store and the supermarket able by their vast turnover[48] to obtain more favorable buying terms, but at

[46] The small builder is perhaps the most obvious exception.

[47] The supermarket must be distinguished from the self-service store, which, though based on the same principle that the customer will select his purchases, is much smaller in size. A supermarket must be at least 2000 sq. ft. in area, and, in fact, there is a tendency for it to be increased in the United Kingdom from the usual 3000-6000 sq. ft. to 4000-8000 sq. ft., though even this leaves it far behind the giants of the United States.

Although there is a slight saving in labor costs relative to the increased turnover in the commoner self-service store, it is in the supermarket, with its increased scale of operations, allowing specialization of function, that the real labor economies are obtained.

[48] Due in essence to "impulse buying," there being such a vast display of goods attractively laid out under one roof.

the other end of the line, they are able to cut their selling costs.[49] In consequence, they can afford to sell to the public at lower prices, without any interference with their profit margins.[50] Indeed, the chain stores, such as Marks & Spencer's, have consistently adopted a policy of selling their goods at prices which are exceptionally low, having regard to the quality offered. Of even more importance for the small retailer is the impact of the supermarket, with its technique of introducing "loss leaders"—well-known branded goods deliberately sold below their listed price to induce customers to enter the shop and simultaneously to purchase other wares at the correct price. This kind of competition, coupled with the intrinsic attraction to the customer of the self-service method of shopping, the small distributor with his traditional method of selling finds it immensely difficult to withstand.[51] In fact, since 1950, when the self-service technique first began to make an impact on the United Kingdom—though the supermarket did not begin till after 1954[52]—it has been estimated that some 5000 grocers have been put out of business.

Moreover, it is usually quite unrealistic for the small concern to retaliate against the supermarket by itself adopting this medium; the cost—estimated at about £50,000 for setting up an average-size supermarket—will generally prove completely prohibitive. Admittedly, the small concern, with its counter service, can give the personal touch which is undoubtedly attractive to some shoppers; but, as has been shown in the United States, in the long run, it is hard economic reality that prevails.[53]

Side by side with the difficulties of the retailer are those of the small manufacturer of consumer goods; more and more, we are seeing the growth in the United Kingdom of branded products.[54] It has even spread to such unlikely articles as furniture.[55] This phenomenon has been accentuated by (1) the remarkable development experienced in the United Kingdom within the last few years in prepackaging, and (2) the impact of national advertising, particularly through the medium of commercial television.[56] The branding of goods, with all that this involves, is generally quite outside the scope of the small firm. It is one thing to sell one's products to a

[49] In the case of the grocery trade, the cost of labor represents a remarkably large proportion of total costs.

[50] The Economist for Aug. 23, 1958 cites the case of a supermarket grossing during the course of a year 19% against an average of 17.7% for the counter-service branches of six grocery multiples. The position of supermarkets is helped by their entry into trades such as butchery, green grocery, and the nonfood trades generally, where profit margins are traditionally higher.

[51] Even if he adopts the small-scale self-service approach, although his turnover will increase, he will still not effect sufficient savings in his running costs to be able to compete with the price-cutting techniques of the supermarket.

[52] When the end of food rationing brought about a swing to main-street shopping and restrictions on building were removed.

[53] At the moment, there are estimated to be only about 200 supermarkets in existence in the United Kingdom. The scope for expansion is, therefore, immense, and at least 5 new ones are being opened each month. Moreover, it is reasonable to assume that the trend will be accentuated by the recent relaxation in credit restrictions for capital projects.

[54] This development is already stronger in Great Britain than anywhere else.

[55] *E.g.*, "G-Plan" & "Link" furniture.

[56] The fact that commercial television is still only received by some 35% of British homes shows what potential still remains for the exploitation of branded goods from this quarter. See also Lloyd, *Some Comments on the British Television Act, 1954*, 23 LAW & CONTEMP. PROB. 165 (1958).

wholesaler and leave the distribution to him; it is quite another to assail the retailer directly and force him to stock one's goods by virtue of the public demand engendered through advertising and other means. The cost of branding and the organization it entails is quite prohibitive. Thus, advertising on commercial television at a peak period on Sunday is £4,000 per minute,[57] and results will not be forthcoming in the absence of a prolonged and sustained campaign. Indeed, the technique of branding is advancing the interests of the big units in industry, but sounding the death-knell of the small concern.

B. Antitrust Legislation

The above-mentioned forces which are at work to undermine the position of the small business are further strengthened, it is submitted, by the Restrictive Trade Practices Act, 1956.[58] Under part two of the Act, agreements for the *collective* enforcement of fixed prices by way of collective withholding of supplies (or conversely by way of collective refusal to order supplies) or by any other means are rendered illegal; and it is from the collective enforcement of price-maintenance agreements that the small trader has in the past derived great protection. Accordingly, the restriction on the power of the trade association to impose sanctions on retailers who do not comply with minimum price agreements or on suppliers who do not attempt to ensure compliance with such agreements by their distributors will, it is submitted, adversely affect the interests of small traders who are unable to compete with the price-cutting of the supermarkets or of the giants of the trade generally.[59]

Admittedly, under section 25 of the Restrictive Trade Practices Act, each individual supplier may bring enforcement proceedings to ensure that his goods are not sold below the agreed minimum, but there is absolutely no guarantee that he will use the weapon reserved to him indiscriminately against small and large trader alike. Under subsection (4) the remedy of injunction is subject to judicial discretion, so that a supplier could not hope to obtain such a remedy against the small distributor, but not the large; or against independent traders, but not against members of his own distributive organization. Nevertheless, *total* inactivity militates against the interests of the small business. In other words, the provisions of section 25 offer little guarantee of protection for the small trader.

But more serious is section 26 of the Restrictive Trade Practices Act, 1956. For subsection (1) specifically envisages that suppliers will, on occasion, allow discounts on resale, and thereby encourages the supermarkets, claiming lower costs of distribution, to put pressure upon suppliers to permit them to sell goods well below their listed price. Moreover, since the amount of discount allowable is under the section on enforceable conditions of re-sale, any disparity of treatment by the supplier

[57] For 30 seconds, it can amount at peak periods during the weekdays to £2,500. Rates in provincial areas only are, of course, less.

[58] 4 & 5 ELIZ. 2, c. 68.

[59] *E.g.*, the co-operative societies.

between small and large retailer is capable of being judicially upheld. Needless to say, such a provision deals a shattering blow to the small business unable to compete with this kind of competition.

Finally, under subsection (2) of section 26, subsidiary companies are deemed to be one with their parent company and each other. Accordingly, where great retailing groups are trading, their various constituent units, though operating commercially as separate entities, can (unlike independent factors) still legally combine together to exert pressure on suppliers, whether in the form of demands for more favorable treatment in the discounts allowable on re-sale or, if it suits them better, in the form of insistence that energetic steps be taken to ensure compliance by all retailers with price-maintenance agreements. Once again, the new Act operates in favor of the large organization at the expense of the small retailer.

C. Hire-Purchase and Credit Sales

One further economic handicap under which the small enterprise labors should be adverted to at this point. An ever-increasing amount of business is being conducted on a hire-purchase or credit sale basis.[60] Indeed, the importance of such credit facilities in promoting consumption is fully appreciated by the Treasury, and during the "credit-squeeze" period through which the United Kingdom has just passed, official acknowledgment was paid to the influence on the economy of hire-purchase trading by the imposition of high minimum deposits and the restriction of credit to a maximum of two years. Thus, although the national hire-purchase debt per person is only about one-sixth of that prevailing in the United States, it is still a very significant factor in the United Kingdom's economy;[61] and it is liable to assume an ever-increasing importance.

The conditions under which goods are sold on a deferred-payments basis are just as important to a person intending to purchase this way as are the cash terms to one who stands in no need of credit; and, needless to say, such baits as "no deposit" and "no service charge," or a comparatively low one such as five per cent per annum or less, have a very material bearing on sales. Moreover, the recent battle over service charges which has flared up in the United Kingdom (sparked off by the entry of the commercial banks into hire-purchase[62] finance and highlighted by the popular press) has made the public particularly alive to these considerations. However, to be able to offer this kind of inducement, the distributor must be able to command the requisite financial resources, and here again, the small business is at a severe disadvantage. Whereas the large concern can afford to finance its own hire-purchase credit, and thereby fix its own terms, the small business is dependent on a finance house, which is, of course, concerned with making a profit out of its lending activities

[60] Of the total business concluded by household goods shops in August 1958, some 31% was transacted in this way. Since then, the relaxation of credit restrictions will have increased the proportion.

[61] In December 1958, it amounted to £604 million. It rose by £120 million during this year, £77 million of it in the last two months, when credit restrictions had been lifted.

[62] Both by their taking up shares in established finance houses and, in some cases, by their directly competing (offering roughly comparable credit facilities, but at the low rate of 5% per annum).

and not in increasing consumer sales. Moreover, the intrinsic overhead costs involved in the collection of hire-purchase debts may often be higher for a finance house than it is for the retailer (if he has the resources to be able to do it himself), because of his greater familiarity with and closer relationship to the actual customer. The result is, then, that the larger distributor who can finance his own hire-purchase sales has a distinct trading advantage over the small retailer who depends on a finance house and cannot offer to his customers such attractive credit facilities as his larger rivals.[63]

IV

THE SOCIAL AND POLITICAL ENVIRONMENT

We must now leave the economic difficulties that confront the small business and turn to consider its position in the social and political environment of today. Socially, the small business is laboring under one particularly severe handicap as against its larger counterpart. The mere size of the big industrial organization renders it socially essential that it should remain in existence. Society cannot allow hundreds or thousands of men and women to be rendered jobless because of the break-up of the company for which they work. Thus, the large concern is, for social reasons, in a strong position to demand bank accommodation (both for immediate working capital and for commitments entered into for the acquisition of buildings and plant) and, when once it has obtained such accommodation, to insist on its continuance and, if need be, its enlargement. The banks cannot withdraw support—not merely because they would be in danger of losing loans already made, but more particularly for the social repercussions that would ensue from such action. Again, a large company is in a position to apply moral pressure on government departments and local authorities for the granting of orders. Or again, if the big organization has got itself well and truly into difficulties, it will almost certainly be taken over by a healthier and more virile enterprise,[64] and its continuity of existence will be preserved.

In contrast, the small business is unable to invoke social considerations. In fact, so far from winning sympathy, its management will generally incur the wrath of public criticism for ever having allowed the business to get into difficulties. The social considerations are not present to act as a mollifying force. Moreover, where artificial economic situations are brought into being by government policy, the small business, through its inability to call social considerations to its aid, may be at a severe disadvantage as against its larger rival. For example, during the "credit-squeeze" period from which the United Kingdom has just emerged, there is some evidence to suggest that the banks were tougher in their lending policy towards

[63] Moreover, the smaller company may find itself unable to withstand the vagaries of government policy in the fixing of minimum hire-purchase deposits. Sudden alterations in consumer demand artificially produced may ruin a small company unable to weather the storm. Thus, it has been estimated that during the last 8 years, three manufacturers a week in the furniture trade (very much the plaything of government hire-purchase regulations) have been put out of business.

[64] Just as building societies that have become financially embarrassed might be taken over by sounder societies in the interests of public confidence in the whole movement.

the small company than the large. Moreover, even if equality of treatment be assumed, the mere restriction of bank credit operates more severely against the small concern than the large. As we have demonstrated above, the private company cannot normally approach the London money market for funds, and so depends much upon bank credit.

Finally, we have to consider the small business in the current political climate. The present government, drawn from the Conservative party, is pledged to the granting of the maximum degree of freedom compatible with the public welfare. For the proper regulation of the economy, the Conservative government puts its faith in monetary controls rather than in the so-called planned economy, which depends on licensing and restrictions on commodity imports, building projects, and the like. Thus, politically (within the limits prescribed by any current monetary regulation), the way is wide open for intense competition between rival businesses, and the small company has the opportunity of either going forward and expanding or else of facing extinction. Should, however, a Labor government be returned at the next election and the doctrine of the planned economy be implemented, what will be the position of the small business?

Historically, the Socialists, with their accent on nationalization and on the co-operative movement, have lent little support to the evolution, growth, and development of the small business. Nevertheless, and whatever the theory of Socialism, it is submitted that the principal effect of a planned economy, as far as the small business is concerned, will be that commercial life will tend to be held in its present groove. Licensing and the other controls of a planned economy are invariably operated on the basis of *existing* size and, by their very nature, are usually not sufficiently flexible to take into account the inherent propensity of the small business to expand or contract rapidly in response to changes in its managerial structure, its financial resources, or economic potentialities. A planned economy stifles movement upwards or downwards and lends full support to the status quo. Whether this is an advantage or disadvantage to the small business (as distinct from the wider and highly debated question of whether it is a benefit to the community at large) must presumably depend on the ambition or caution of the company's management. All that we can say by way of general observation is that the problems facing small business will undoubtedly change with the political theory of the particular government in power at any particular time and that a company's management cannot afford to neglect the present and future political patterns of the economy.

SUMMARY

We see from our short survey of the present-day position of the small business in the United Kingdom that its problems are manifold and various. Although it may function in the shape of a sole trading concern, a partnership, or a limited company (each of which forms has its own advantages and disadvantages), the small business can conveniently be defined as any enterprise which does not enjoy the benefit

of a public quotation for its share capital. Generally, the small business will take the form of a private limited company, and the status it thereby assumes imposes upon it certain severe handicaps. Quite apart from its inevitable exposure to the possibility of family feuds and its dependence on the personality of its managing director, it will meet with immense difficulty in finding permanent capital. Indeed, the only really sure way of accumulating permanent funds is by the retention of past profits. Here again, however, the success of this policy will depend on the extent to which present taxation allows the private company to plough back its earnings; and the way in which the small company is taxed more severely than its quoted counterpart is only too clearly in evidence.

Again, if we turn from the difficulties that flow from the mere legal status of the private company and consider its economic problems, we find that as far as the small retailing business is concerned, it is very much at the mercy of the new technological advances in distribution manifested in the rapid expansion of the chain store and the development of the supermarket; and that on the manufacturing side, the small producer of consumer goods is unable to compete with its larger rival in the manufacture of branded products. Moreover, the position is further prejudiced, it is submitted, by part two of the Restrictive Trade Practices Act, 1956, and by the inability of the small retailing concern to offer credit terms as attractive as those of its larger competitor.

If we pass on to social and political considerations, we find the small company brought face to face with further problems. Society cannot permit the dissolution of the large concern, with all that this would imply in terms of unemployment and human misery. The small company, however, is precluded from invoking such sympathetic considerations. As far as politics are concerned, whereas under a Conservative government the small company can reasonably anticipate a high degree of freedom to expand or contract, under Socialist rule the tendency would be for the continuance of the status quo. We see, then, that legally, economically, socially, and politically the small business in the United Kingdom is truly encompassed about by real and significant problems.

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